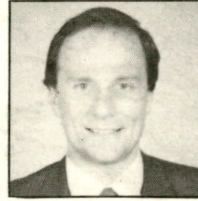


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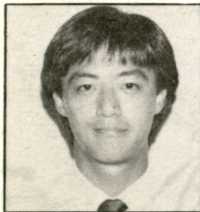
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AUSTRALIA: THE BOND MARKET IN RETREAT

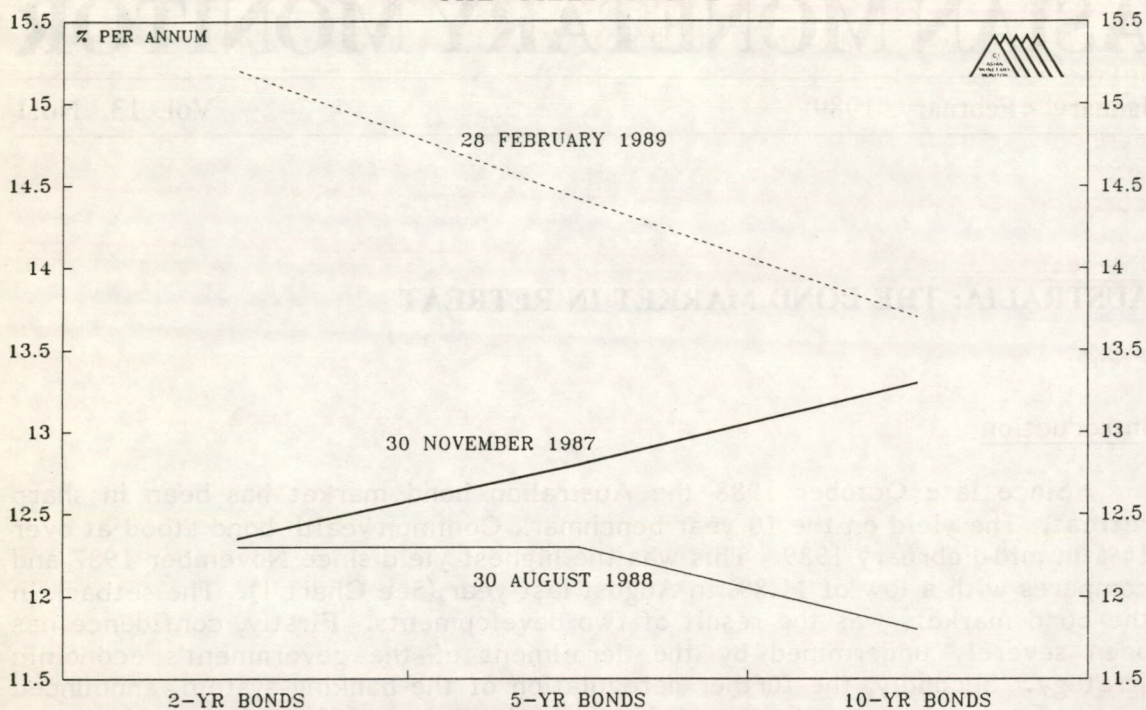
Introduction

Since late October 1988 the Australian bond market has been in sharp retreat. The yield on the 10 year benchmark Commonwealth bond stood at over 14% in mid-February 1989. This was the highest yield since November 1987 and compares with a low of 11.8% in August last year (See Chart 1). The setback in the bond markets was the result of two developments. Firstly, confidence has been severely undermined by the derailment of the government's economic strategy. Secondly, the further deregulation of the banking system, announced by the Treasurer in last September's budget for fiscal 1988/89, has resulted in a net reduction in demand for government securities by the banking sector, who are the largest holders of government debt.

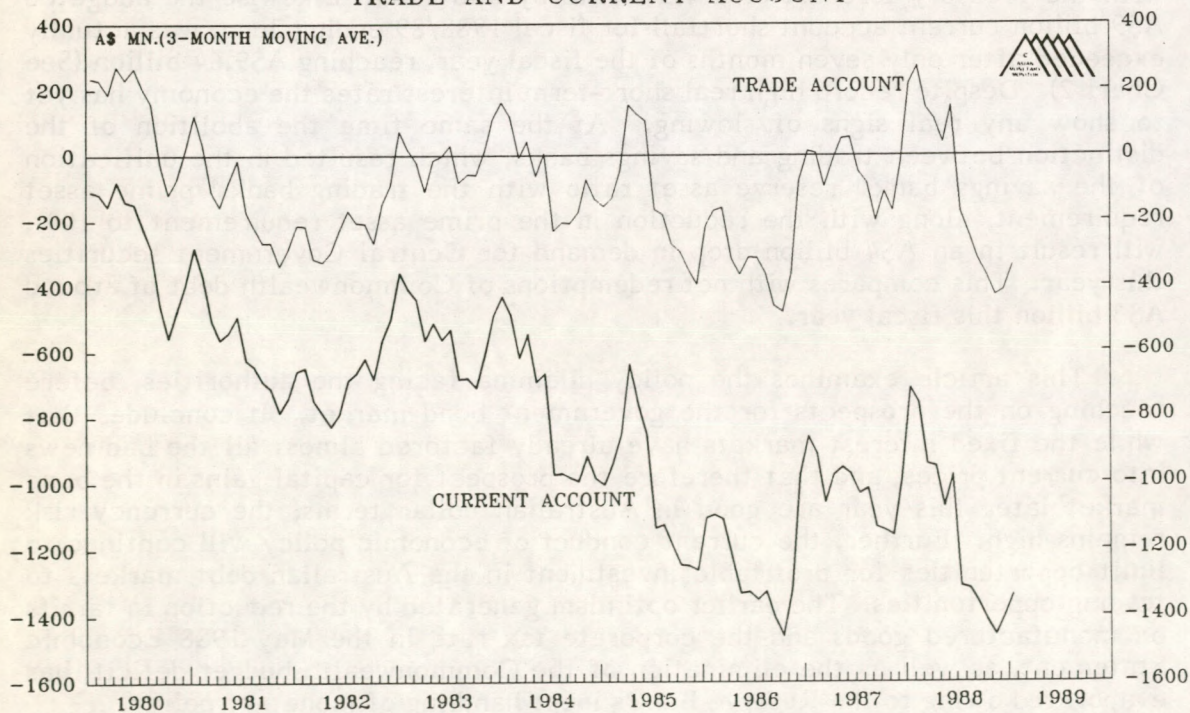
By the fourth quarter of 1988 the inflation rate as measured by the consumer price index, had accelerated to reach 7.7% annualised. This compares with the Treasury forecast of a 4.5% rate by mid-1989. Likewise the budgeted A\$9 billion current account shortfall for fiscal 1988/89 ending June, was actually exceeded after only seven months of the fiscal year, reaching A\$9.64 billion (See Chart 2). Despite record high real short-term interest rates the economy has yet to show any real signs of slowing. At the same time the abolition of the distinction between trading and savings banks, which resulted in the unification of the savings banks' reserve asset ratio with the trading banks' prime asset requirement, along with the reduction in the prime asset requirement to 10%, will result in an A\$4 billion drop in demand for Central Government securities this year. This compares with net redemptions of Commonwealth debt of around A\$3 billion this fiscal year.

This article examines the policy dilemma facing the authorities, before touching on the prospects for the government bond market. It concludes that while the fixed interest markets have already factored almost all the bad news into current prices, and that therefore the prospect for capital gains in the bond market later this year are good in Australian dollar terms, the currency risk remains high. Further, the current conduct of economic policy will continue to limit opportunities for profitable investment in the Australian debt markets to trading opportunities. The earlier optimism generated by the reduction in tariffs on manufactured goods and the corporate tax rate in the May 1988 Economic Statement, as well as the elimination of the Commonwealth budget deficit, has evaporated owing to the Reserve Bank's inept handling of monetary policy.

AUSTRALIA: CHART 1 THE YIELD CURVE



AUSTRALIA: CHART 2 TRADE AND CURRENT ACCOUNT



The economic and monetary background.

The growing imbalances in the economy reflect three major shortcomings in the conduct of economic policy. Firstly, the reliance on interest rates to influence credit demand and consumer spending, at a time when the real economy remains highly regulated. Secondly, an excessive reliance on the wages accord to restrain inflation. Thirdly, the authorities' misinterpretation that the current stance of fiscal policy is in fact deflationary.

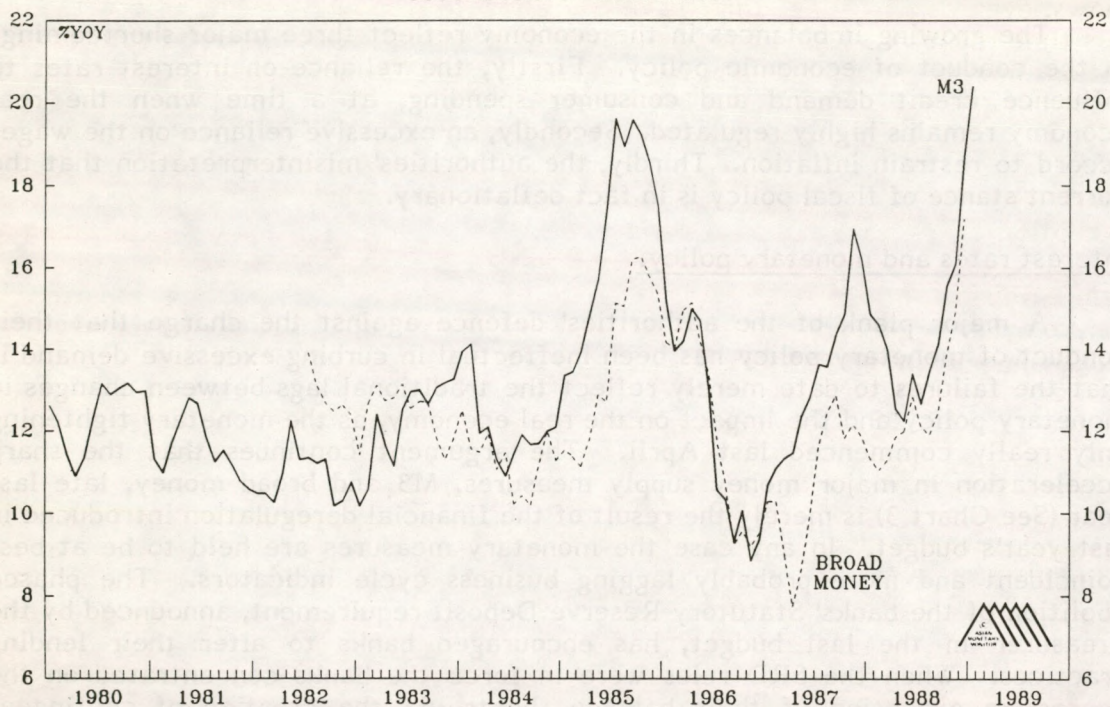
Interest rates and monetary policy.

A major plank of the authorities' defence against the charge that their conduct of monetary policy has been ineffectual in curbing excessive demand is that the failures to date merely reflect the traditional lags between changes in monetary policy and the impact on the real economy, as the monetary tightening only really commenced last April. The argument continues that the sharp acceleration in major money supply measures, M3 and broad money, late last year (See Chart 3) is merely the result of the financial deregulation introduced in last year's budget. In any case the monetary measures are held to be at best coincident and more probably lagging business cycle indicators. The phased abolition of the banks' Statutory Reserve Deposit requirement, announced by the Treasurer in the last budget, has encouraged banks to alter their lending practices. When the SRD rules were in force the banks concentrated on the aggressive expansion of their balance sheets via the creation of contingent liabilities, mainly bankers' acceptances, which were not covered by the SRD requirements. Since the abolition of the requirements the banks have switched back to a traditional approach of overdraft and term loan lending, resulting in an expansion of bank deposits. The explosive growth in M3 and broad money is therefore held to be merely the result of re-intermediation.

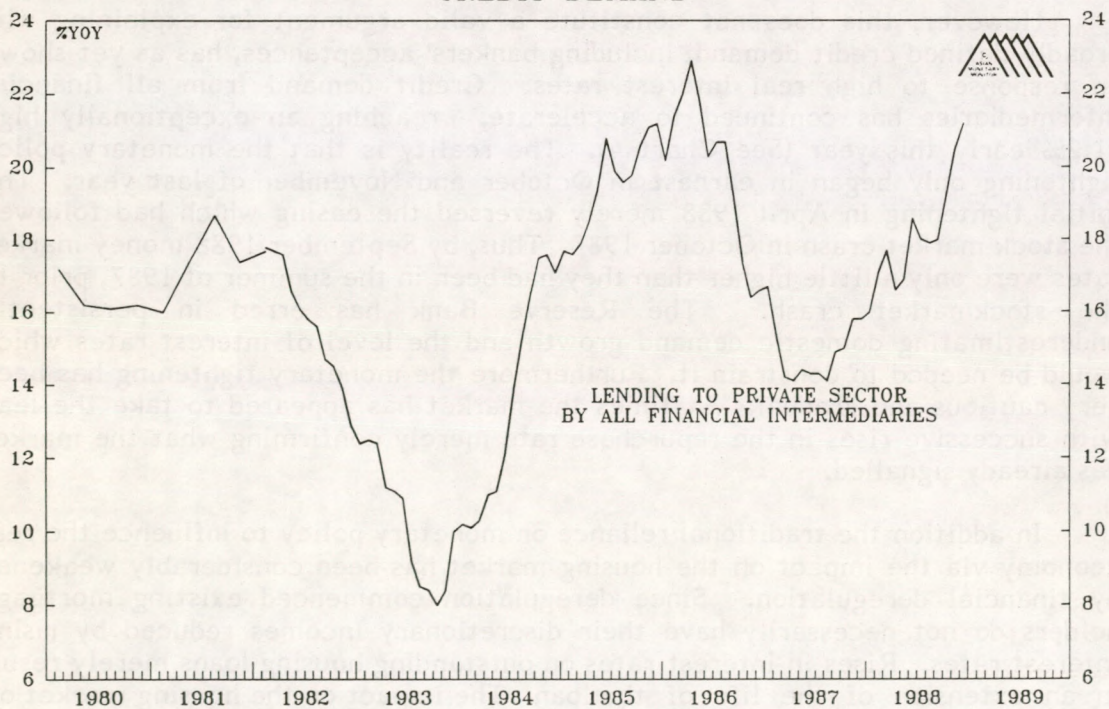
However, this does not constitute a valid argument for explaining why broadly defined credit demand, including bankers' acceptances, has as yet shown no response to high real interest rates. Credit demand from all financial intermediaries has continued to accelerate, reaching an exceptionally high 21.2% early this year (See Chart 4). The reality is that the monetary policy tightening only began in earnest in October and November of last year. The initial tightening in April 1988 merely reversed the easing which had followed the stock market crash in October 1987. Thus, by September 1988 money market rates were only a little higher than they had been in the summer of 1987, prior to the stockmarket crash. The Reserve Bank has erred in persistently underestimating domestic demand growth and the level of interest rates which would be needed to constrain it. Furthermore the monetary tightening has been very cautious and gradual. At times the market has appeared to take the lead with successive rises in the repurchase rate merely confirming what the market has already signalled.

In addition the traditional reliance on monetary policy to influence the real economy via the impact on the housing market has been considerably weakened by financial deregulation. Since deregulation commenced existing mortgage holders do not necessarily have their discretionary incomes reduced by rising interest rates. Rises in interest rates on outstanding housing loans merely result in an extension of the life of the loan. The impact on the housing market of

AUSTRALIA: CHART 3
MONETARY GROWTH



AUSTRALIA: CHART 4
CREDIT DEMAND



rising interest rates is therefore limited to the new loans. However, as Chart 5 shows, even new housing starts have been slow to respond to rising interest rates this time round. Similarly the emergence of a sophisticated financial futures and options market means that a rising interest market can be hedged against.

In a deregulated financial environment rising interest rates are therefore no guarantee that loan demand will be curbed, unless pushed to punitive levels which are persisted with for a prolonged period of time. With only a few exceptions central banks worldwide no longer apply rigid targets for money growth rates, but instead seek a level of real short term interest rates which is compatible with sustainable non-inflationary growth. The reliance on altering the relative price of credit rather than restricting the quantity of money has lengthened the lag between changes in monetary policy and the impact on the real economy and inflation. In Australia the lag is lengthened considerably more by the failure of the pace of deregulation in the real economy to match that in the financial sector. In the U.K., by way of contrast, the monetary tightening also began last April and despite being far less pronounced than in Australia, has already begun to choke off excess demand. In previous articles in AMM (See Vol 11 No. 6 and Vol 12 No. 5) we have touched upon the distortions existing in the real economy, in particular in the labour markets and on the trade front. The Economic Statement of May announced that tariffs on manufactured goods imports would be reduced over a three year period from an average 25% to 12.5%. But tariffs in the four key labour intensive areas of motor vehicles, textiles, clothing and footwear will still remain at over 100% at the end of the period.

High real short-term interest rates have little effect on loan demand from large companies shielded by high tariff barriers, but are highly destructive to small companies who do not enjoy this advantage. As such, the way in which monetary policy is conducted is totally counterproductive to the authorities' desire to diversify the manufactured export base and will in the long run undermine confidence in the country. Irrespective of whether short-term interest rates stay high this will ultimately undermine the currency. In any case, notwithstanding the fact that the Australian dollar was "talked down" by the authorities, by over 10%, in late February, the currency remains vulnerable to falling interest rates later this year. By this time interest rates should be falling in the wake of a slowing economy and an impending election.

There are two policy alternatives: accelerate the deregulation of the real economy, which at present is seen as politically infeasible owing to union opposition; or actively operate on the monetary base. Apart from the traditional argument that the second option would result in a highly volatile trend in interest rates, which in any case has been the case under the current arrangement (See Chart 5), the phased abolition of the Statutory Reserve Deposit ratio would make it rather a complex task to target the monetary base. Nevertheless, it would still be possible to constrain its growth so as to achieve a desirable rate of growth for the broader aggregates. With the deregulation of the financial sector virtually complete these aggregates should become less subject to distortion, and velocity should begin to track a more predictable path. In the current environment, however, the option seems unlikely to be pursued.

Without an effective monetary policy the implication is that domestic demand will remain stronger far longer than the consensus predicts. Short-term rates will therefore remain high past mid-year and the current account shortfall will continue to widen. With the co-ordinated round of short-term interest rate hikes in the major industrialised countries in January and February possibly signalling that base metals prices have peaked, it is probable that this year's current account shortfall will approach A\$14 billion. Prospects for an immediate improvement in the new fiscal year are not therefore auspicious. The Treasurer is politically committed to the granting of personal tax reductions in June, and with the Reserve Bank automatically accommodating credit demand from the banking system, though at rates of its own choosing, the tax reductions are likely to be financed - in effect - by money creation.

The Wages Accord.

In this environment inflation should also trend up initially before the impact of dearer money begins to bite. The counter-argument advanced to this scenario is that the wages accord will constrain spending and curb inflation. In previous editions of Asian Monetary Monitor we have highlighted the mis-allocation of resources that results from the wages accord. It is also debatable as to whether inflation is contained by the wages accord for any length of time. The combination of rapid growth in the money supply and the wages accord is resulting in a change in the relative prices between labour, which are artificially determined, and other factors of production which are determined by the free market. If the increase in real wages is held below the increase in productivity this results in increased demand for labour, placing mounting pressure on the wages accord. This essentially is what has begun to occur in 1988 as demands for larger nominal wages increase. The wage accord therefore achieves little other than to change the relative price of labour for a short period.

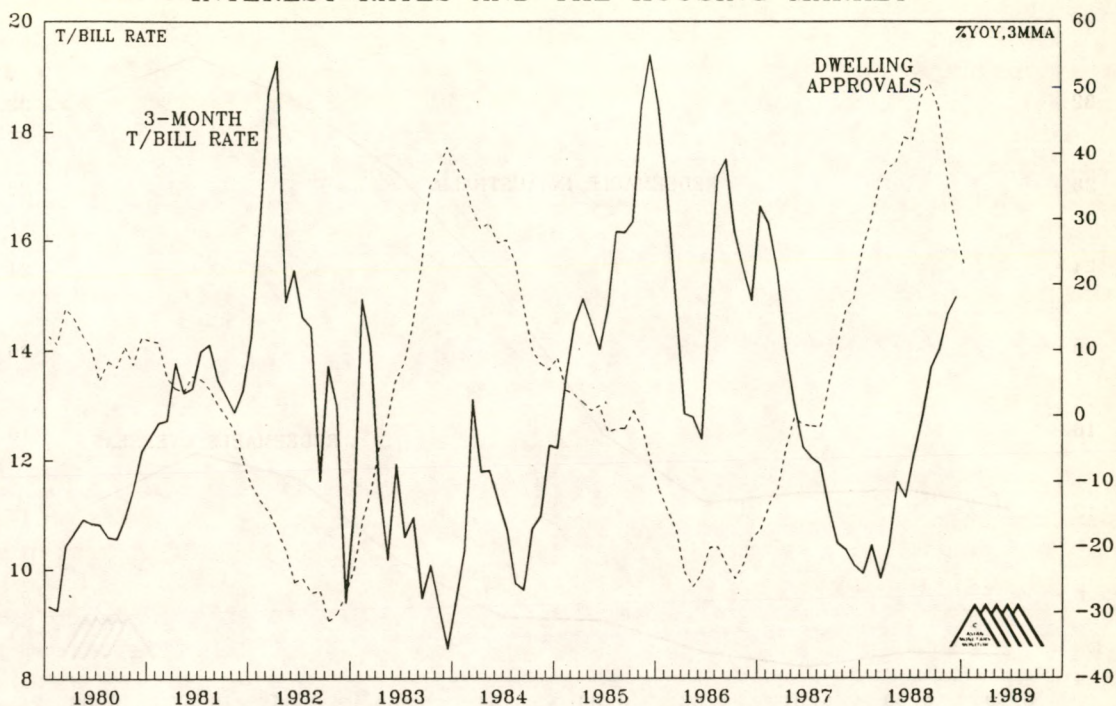
Fiscal Policy.

The other argument advanced against the notion of a prices and current account deficit blowout is that fiscal policy is contractionary. However, this is debatable. At first glance the policy of using the Commonwealth budget surplus to repay debt (see charts 7 and 8) seems to result in no increase in the reserves of the banking system as the total outstanding debt diminishes. The deposits of the government with the Reserve Bank are initially credited owing to the fiscal surplus but subsequently debited as Commonwealth debt is retired. However, as the overall public sector borrowing requirement is in balance owing to the deficit run by the states the ultimate impact is to expand the base of the banking system.

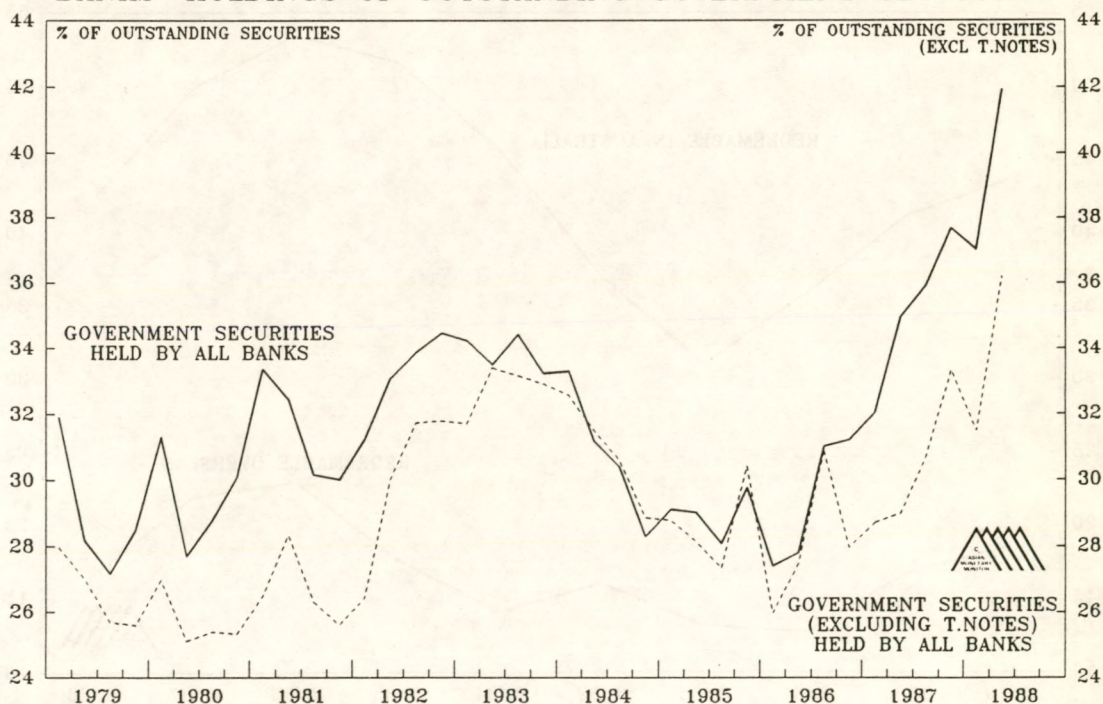
Prospects for the Bond Market.

If the scenario of a rising trade shortfall and accelerating inflation is accepted, what are the implications for the bond markets? The immediate issues are two-fold. How much debt is likely to be retired over the next few years and what impact will this have on demand? To what extent will this offset the gloomy outlook for inflation and the currency?

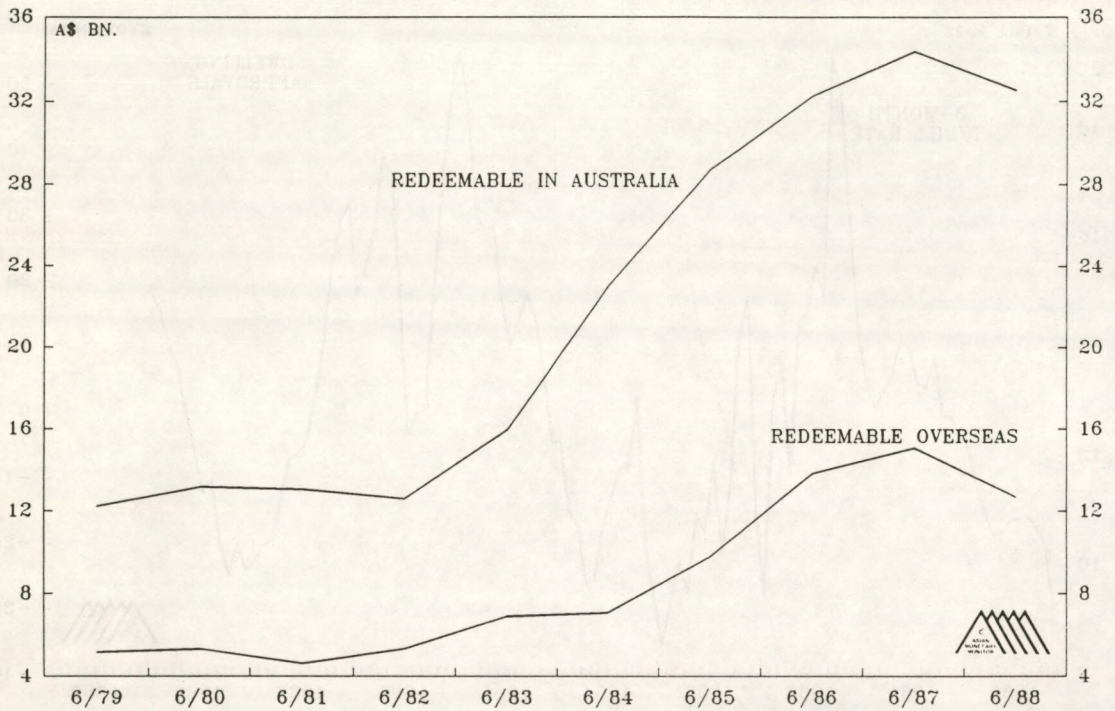
AUSTRALIA: CHART 5 INTEREST RATES AND THE HOUSING MARKET



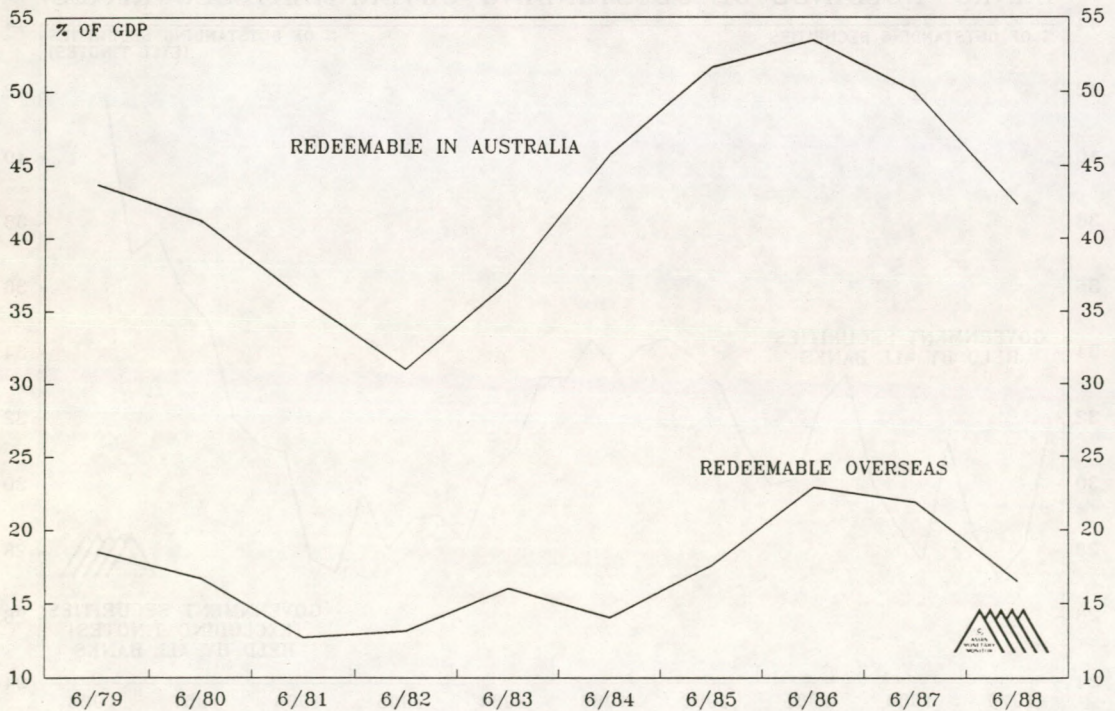
AUSTRALIA: CHART 6 BANKS' HOLDINGS OF OUTSTANDING GOVERNMENT SECURITIES



AUSTRALIA: CHART 7
OUTSTANDING COMMONWEALTH GOVERNMENT SECURITIES

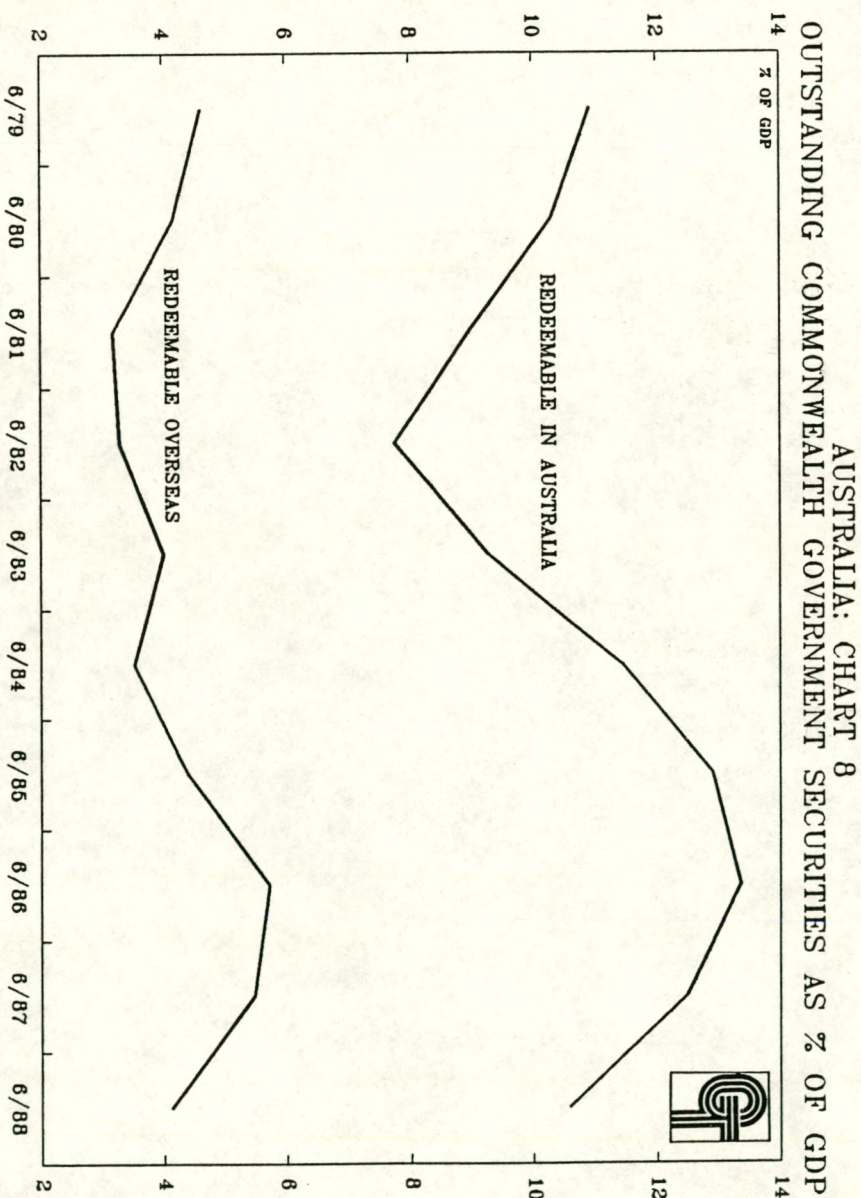


AUSTRALIA: CHART 8
OUTSTANDING COMMONWEALTH GOVERNMENT SECURITIES as % OF GDP



Erratum

This chart is a corrected version of Chart 8, which appears on Page 8 of this publication.



Next year's Commonwealth Budget surplus is likely to reach around A\$6 billion (after tax reductions of A\$5 billion), of which it is assumed roughly half will be used to redeem outstanding domestic debt. This represents approximately 6% of the outstanding value of domestically held Government debt. Nevertheless, the immediate prospects for the bond market are not encouraging. The consumer price index for the March quarter, due in April, is likely to rise at an annualised rate of over 8%. Further, although economic activity is forecast to slow in the second half of the year, resulting in declining short term interest rates, and debt retirement will be accelerated, the prospects for the longer end of the yield curve are not encouraging. With inflationary expectations likely to be fanned by a declining currency, the better opportunities should be found at the short end of the curve around the two year area.

HONG KONG: THE SYMPTOMS AND CAUSES OF STRUCTURAL CHANGE

Because Hong Kong is a very open economy the cyclical pattern of growth in Hong Kong tends to be dominated by the business cycles of the major economies. In particular, given that the U.S. is Hong Kong's major partner in domestic trade and also that the Hong Kong monetary system is linked to the U.S. monetary system via the exchange rate link, the business cycle of the U.S. exerts a major influence on Hong Kong's economy. However, underlying the cyclical pattern of growth, at least over the past two business cycles for Hong Kong, there is an ongoing secular change taking place involving a structural shift in Hong Kong's economy. Three, potentially related, factors can be identified as causes of, and possible influences on, this structural shift: Firstly, the major shift of manufacturing production by Hong Kong companies into south China; secondly, the growth in demand for services from Hong Kong (tourism, managerial and technical support services, port facilities, finance and business services etc.) related to the opening up of China, and also to the growing integration of the Asia-Pacific region generally; thirdly, a lower level of confidence in the future of Hong Kong on the part of Hong Kong people, showing up in high levels of emigration and of gross capital outflows from Hong Kong. Each of these longer-term influences on the development of the Hong Kong economy is well-known and has been the subject of much discussion and study. Nevertheless, confusion often arises between the cyclical and structural influences on the economy and the respective implications for economic variables such as GDP growth, the trade position, employment and wage growth, and inflation. Indeed, at times such as the present, when the peak of the business cycle has been coinciding with a period of particularly rapid structural adjustment, it is difficult, if not impossible, to separate out the impact of normal business cycle fluctuations from the effects of structural change on the economy. Against this background, this article considers the broad impact that structural change is likely to have, over time, on the key variables of the Hong Kong economy.

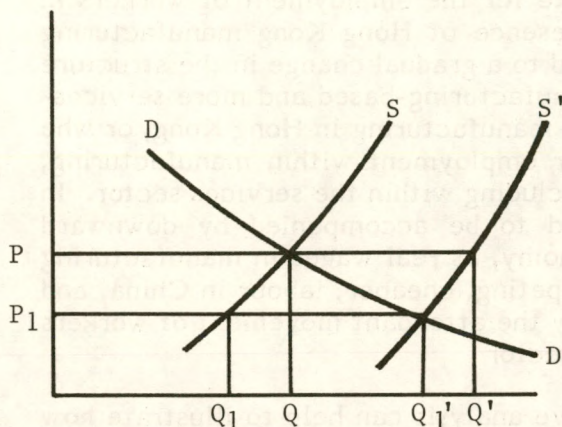
Shift of Manufacturing Production into South China.

The major impetus to structural change in the Hong Kong economy has been the opening up of the People's Republic of China under China's economic reform, begun with the "Four Modernisations" programme of December 1978. Prior to 1979 China was one of the world's most closed economies. However, the last ten years has seen enormous growth in China's foreign trade and cross-border investment flows. Since 1979 China's total external trade, as a fraction of national income, has risen from only 12% to over a third currently (see Asian Monetary Monitor Vol 12. No. 2).

From the point of view of Hong Kong's manufacturers the opportunity for direct investment across the border in south China has given Hong Kong companies access to a plentiful supply of labour at comparatively low wage rates, allowing them considerable extra production flexibility. The result has been enormous growth in the presence of Hong Kong manufacturers in southern

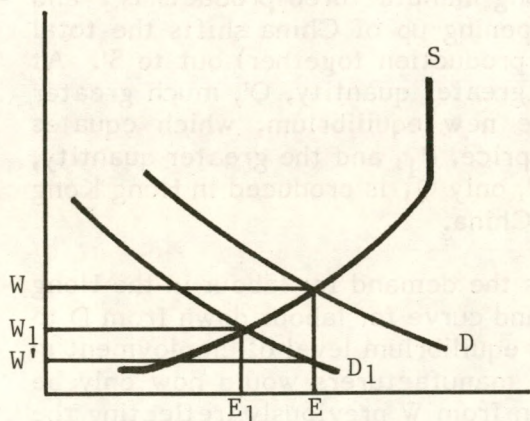
HOW THE SHIFT OF PRODUCTION TO CHINA CAN AFFECT HONG KONG'S LABOUR MARKET.

1) Goods Market



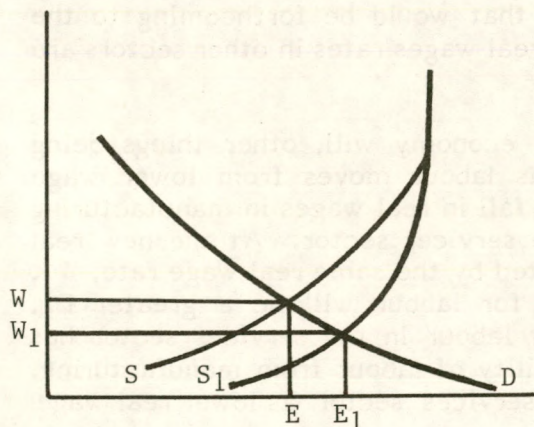
S is the supply curve for Hong Kong manufacturers. Production from China shifts the supply out to S'. The new equilibrium price is a lower P_1 but the total quantity supplied is a greater Q_1' . However at this price only Q_1 is supplied from Hong Kong, the rest ($Q_1' - Q_1$) from China.

2) Hong Kong's Labour Market (Manufacturing)



Lower production in Hong Kong reduces the demand for labour in manufacturing to D_1 . The new equilibrium for the manufacturing sector is at a lower level of employment, E_1 , and a lower level of real wages, W_1 .

3) Hong Kong's Labour Market (Services)



The fall in real wage rates to W_1 in manufacturing will also be reflected in the services sector. At the new real wage rate the quantity of labour demanded in services has increased to E_1 . Effectively the short-term supply curve for labour has shifted to S_1 .

China, with Hong Kong enterprises now estimated to employ over one million workers in Guangdong province, substantially more than the total number of workers employed in the manufacturing sector of Hong Kong itself.

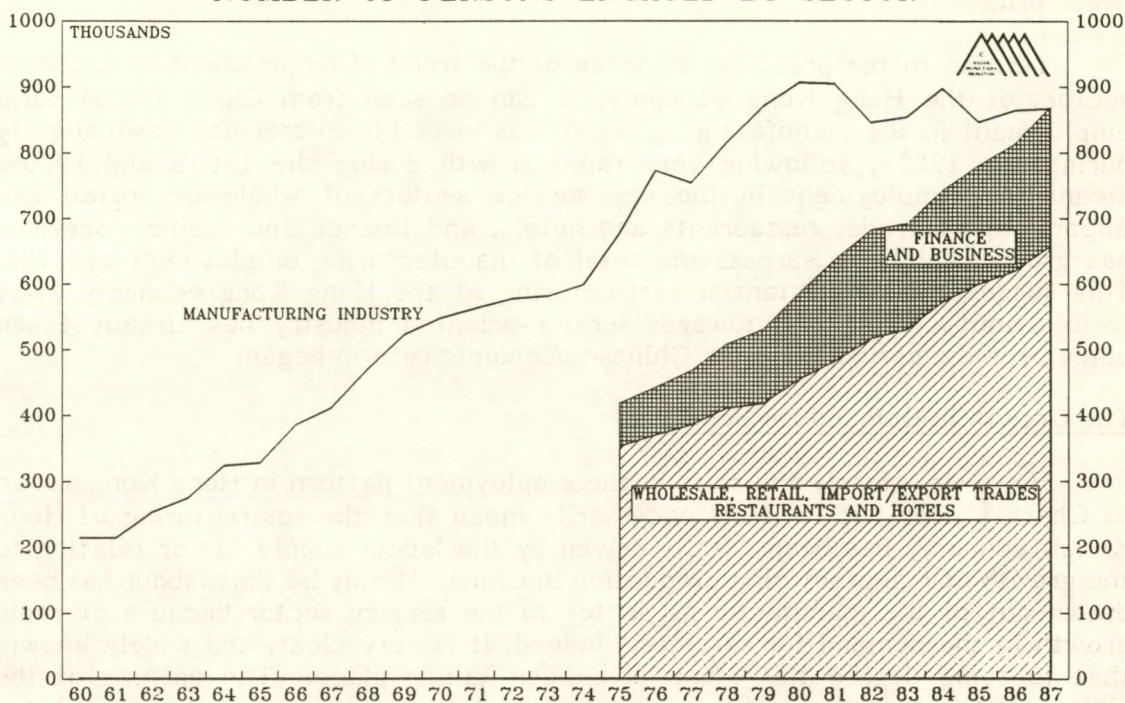
To some degree the employment of workers in China by Hong Kong companies is, over time, likely to substitute for the employment of workers in Hong Kong. To this extent a growing presence of Hong Kong manufacturing companies in China is in itself likely to lead to a gradual change in the structure of Hong Kong's economy towards a less manufacturing-based and more services-oriented economy. Workers displaced from manufacturing in Hong Kong, or who otherwise might have expected to look for employment within manufacturing, will have to seek employment elsewhere, including within the services sector. In a static situation this process would tend to be accompanied by downward pressure on real wages throughout the economy, as real wages in manufacturing would be depressed by the presence of competing, cheaper, labour in China, and real wages in services would be depressed by the attendant movement of workers out of manufacturing and into the services sector.

A very simple demand and supply curve analysis can help to illustrate how this process might work in a static (i.e. with no economic growth) situation. (See the box on page 11). The original demand and supply situation in the goods market facing Hong Kong manufacturers is shown by the D and S curve in the top diagram. The equilibrium price for Hong Kong manufactured products is P and the quantity supplied is Q. However, the opening up of China shifts the total supply curve (for Hong Kong and new China production together) out to S'. At the previous price for the products a much greater quantity, Q', much greater than demand, would now be supplied. The new equilibrium, which equates demand with the new supply, is at the lower price, P_1 , and the greater quantity, Q_1' . However, of this quantity produced, Q_1' , only Q_1 is produced in Hong Kong while the remainder ($Q_1' - Q_1$) is produced in China.

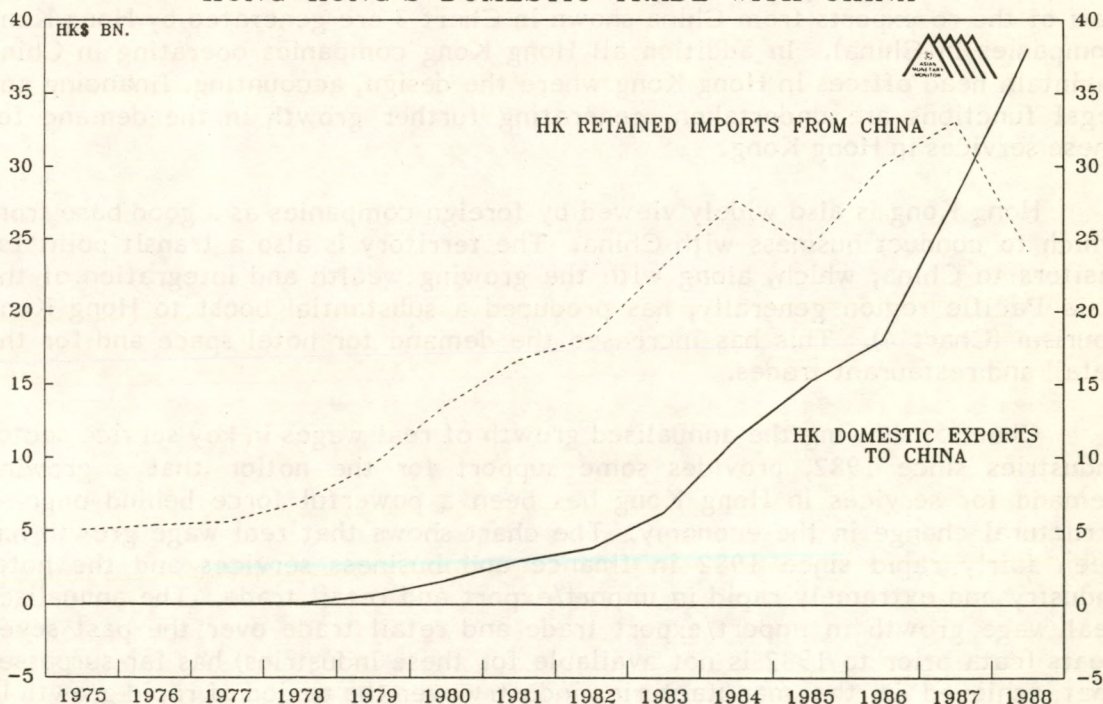
Lower production in Hong Kong reduces the demand for labour in the Hong Kong manufacturing sector, shifting the demand curve for labour down from D to D_1 (second diagram). To support the previous equilibrium level of employment in manufacturing in Hong Kong, E, Hong Kong manufacturers would now only be prepared to pay a real wage rate of W' , down from W previously (reflecting the availability of cheaper labour in China). The new equilibrium, which equates the demand for and the supply of labour in manufacturing is at the lower level of employment E_1 , and the lower real wage rate, W_1 . (note that the, short-term, supply curve denotes the supply of labour that would be forthcoming to the sector at each level of real wages, assuming real wages rates in other sectors are held constant at existing levels).

Because real wages across the whole economy will, other things being equal, tend to equality in the long-run (as labour moves from lower wage occupations to higher wage occupations) the fall in real wages in manufacturing will gradually bring down real wages in the services sector. At the new real wage rate, W_1 (see the third diagram), dictated by the same real wage rate, W_1 , in the manufacturing sector, the demand for labour will be a greater E_1 . Effectively the short-term supply curve for labour in the services sector has shifted from S to S_1 , reflecting the availability of labour from manufacturing. The result is greater employment in the services sector as lower real wage

HONG KONG: CHART 1
NUMBER OF PERSONS ENGAGED BY SECTOR



HONG KONG: CHART 2
HONG KONG'S DOMESTIC TRADE WITH CHINA



rates allow producers of services to supply a greater quantity of services at lower prices.

Turning to the practical evidence of the trend of employment in different sectors of the Hong Kong economy, it can be seen from Chart 1 that total employment in the manufacturing sector has indeed been trending down slightly during the 1980's, following very rapid growth during the 1960's and 1970's. Meanwhile, employment in the key service sectors of wholesale, retail and import/export trade, restaurants and hotels, and finance and business services has grown rapidly to surpass the total of manufacturing employment by 1987. This suggests that substantial restructuring of the Hong Kong economy away from manufacturing and towards service-oriented industry has already taken place over the period since the Chinese economic reform began.

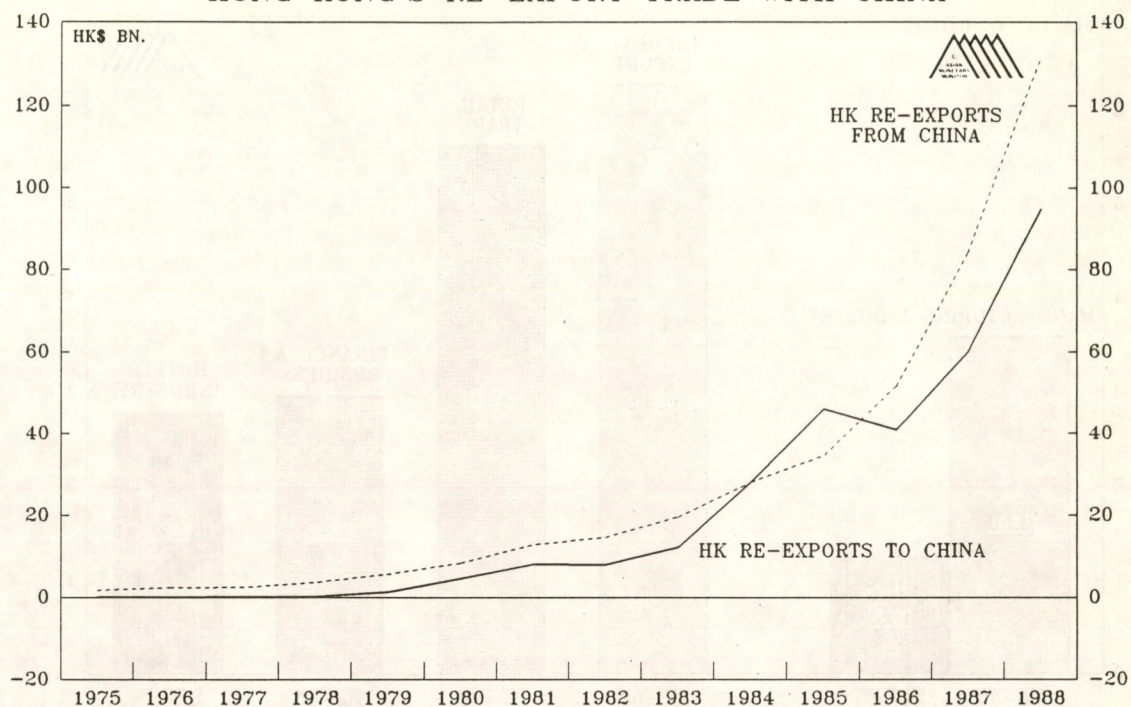
The Growth in Demand for Services.

However, clearly the shift in the employment pattern in Hong Kong shown in Chart 1 does not in itself necessarily mean that the restructuring of Hong Kong's economy has been totally driven by the labour supply factor relating to the growth of manufacturing production in China. It may be that labour has been drawn out of the manufacturing sector to the service sector because of rapid growth in the demand for services. Indeed, it is very clear, and widely known, that to some degree this must have been taking place. The opening of the Chinese economy has produced tremendous opportunities for business in Hong Kong. Hong Kong's domestic trade with China (Chart 2) and re-export trade with China (Chart 3) has grown extremely rapidly since 1978, generating increasing demand for port facilities in Hong Kong. A substantial part of the trade growth has itself been the result of the growing operations of Hong Kong companies in China, as these companies import components for, and export finished products from, their Chinese operations via Hong Kong. (It is estimated that more than half of the re-exports from China shown in Chart 3 are generated by Hong Kong companies in China). In addition all Hong Kong companies operating in China maintain head offices in Hong Kong where the design, accounting, financing and legal functions are undertaken, generating further growth in the demand for these services in Hong Kong.

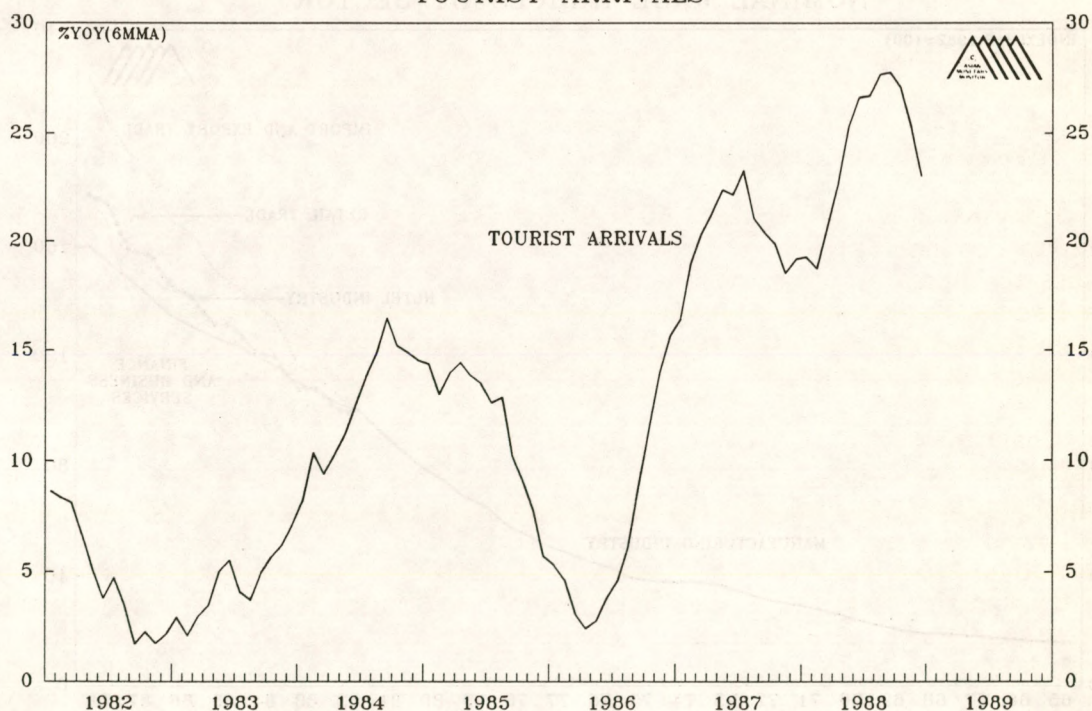
Hong Kong is also widely viewed by foreign companies as a good base from which to conduct business with China. The territory is also a transit point for visitors to China, which, along with the growing wealth and integration of the Asia Pacific region generally, has produced a substantial boost to Hong Kong tourism (Chart 4). This has increased the demand for hotel space and for the retail and restaurant trades.

Chart 5, showing the annualised growth of real wages in key service sector industries since 1982, provides some support for the notion that a growing demand for services in Hong Kong has been a powerful force behind ongoing structural change in the economy. The chart shows that real wage growth has been fairly rapid since 1982 in finance and business services and the hotel industry and extremely rapid in import/export and retail trade. The annualised real wage growth in import/export trade and retail trade over the past seven years (data prior to 1982 is not available for these industries) has far surpassed that achieved in the manufacturing industry over the period of rapid growth in

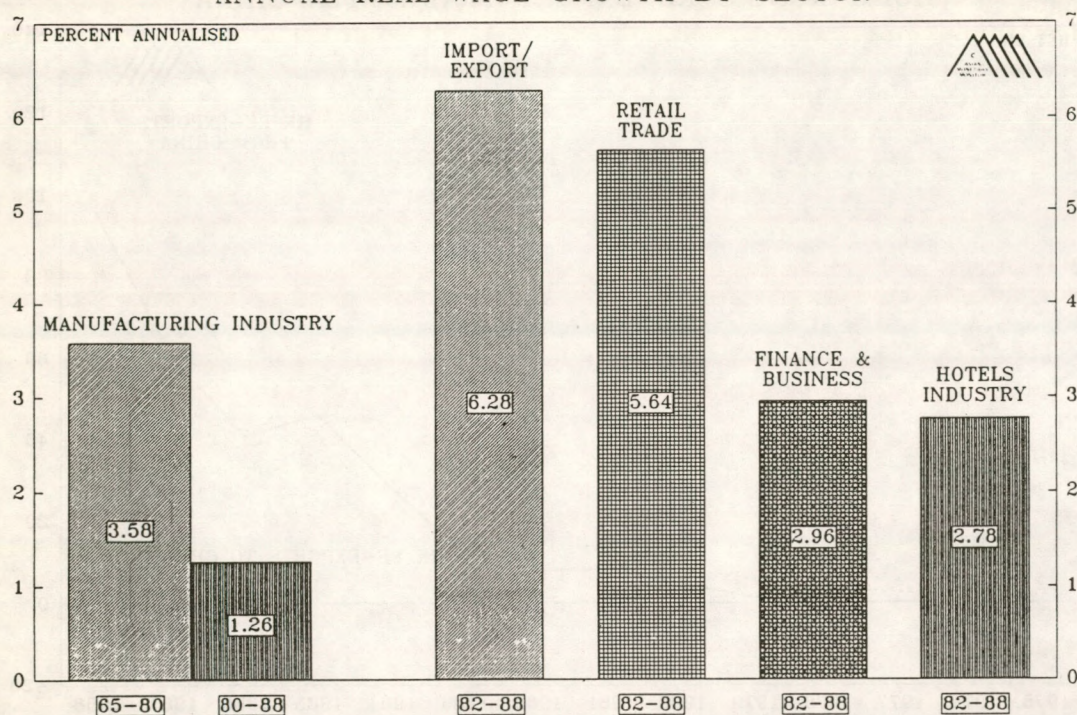
HONG KONG: CHART 3
HONG KONG'S RE-EXPORT TRADE WITH CHINA



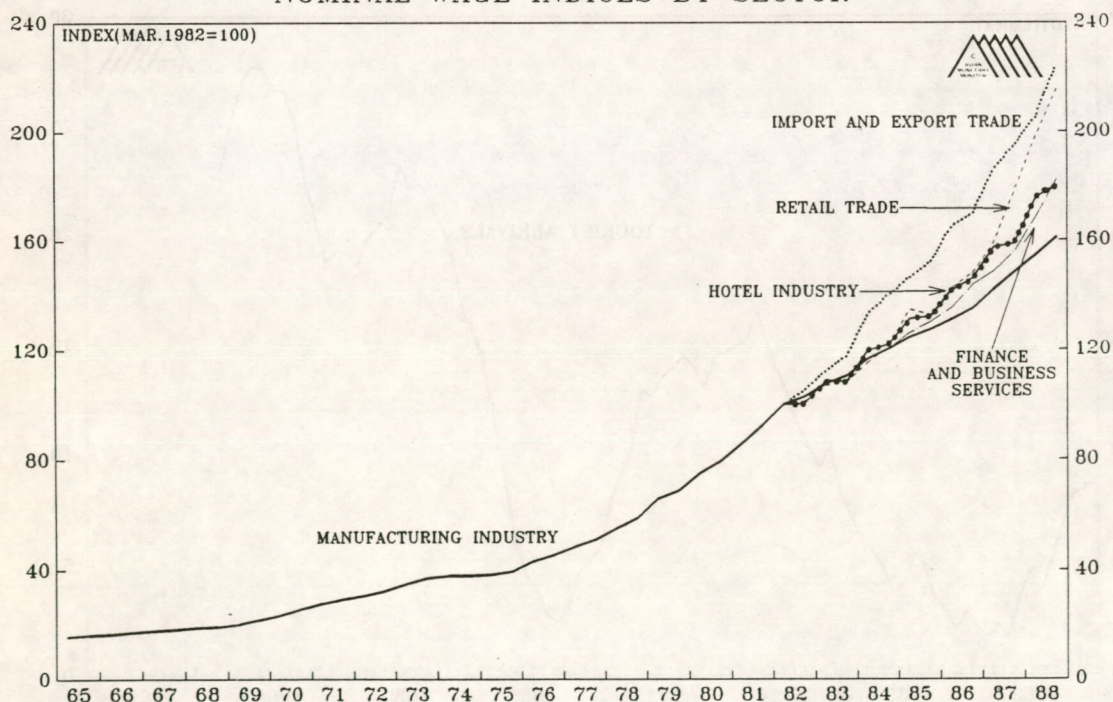
HONG KONG: CHART 4
TOURIST ARRIVALS



HONG KONG: CHART 5
ANNUAL REAL WAGE GROWTH BY SECTOR



HONG KONG: CHART 6
NOMINAL WAGE INDICES BY SECTOR



manufacturing between 1965 and 1980. In itself this supports the notion of demand-led growth in the service sector. As explained earlier, if the growth in service employment were instead supply-led and related to the need for the service sector to absorb surplus labour from manufacturing, it would tend to imply a lower, rather than a higher, rate of growth of real wages. However, the chart also shows that the annualised growth rate of real wages in manufacturing has been substantially lower since 1980 than in the period between 1965 and 1980 (little more than a third of the growth rate). When taken together with flat or falling total employment in manufacturing over the same period this does suggest a reduction in demand for labour in manufacturing and goes contrary to the notion of there being a generalised shortage of labour in Hong Kong.

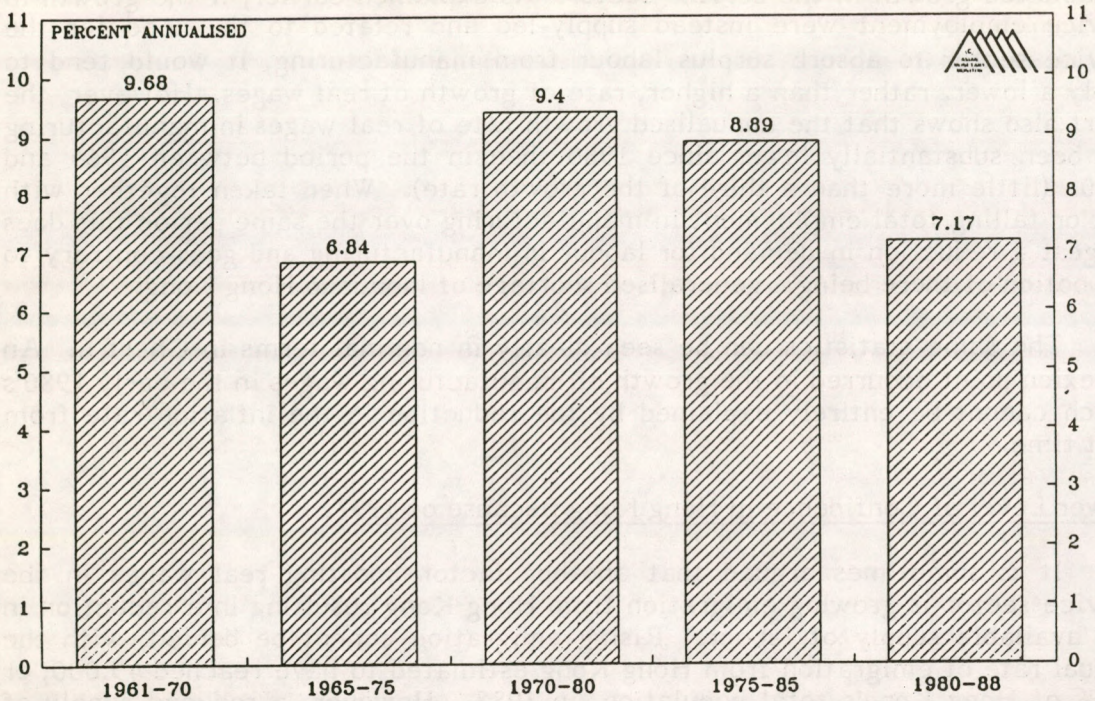
The same statistics can be seen clearly in nominal terms in Chart 6. An inflexion point occurred in the growth of manufacturing wages in the early 1980's which cannot be entirely explained by the reduction in the inflation rate from that time.

Lower Level of Confidence in Hong Kong Because of 1997.

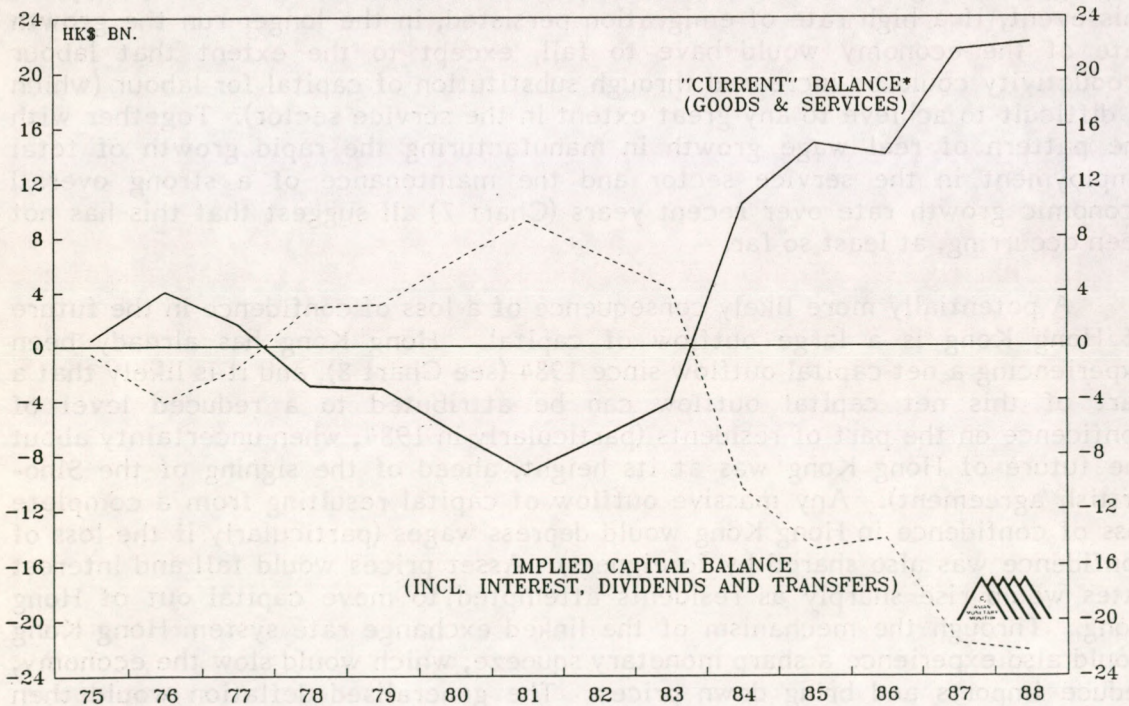
It is sometimes argued that another factor boosting real wages in the service sector is growing emigration from Hong Kong resulting in a reduction in the available supply of labour. Rising emigration cannot be denied, with the annual rate of emigration from Hong Kong estimated to have reached 45,000, or 0.8% of Hong Kong's total population, in 1988. However, a reduced supply of labour due to emigration clearly cannot on its own account for the developments in Hong Kong's labour market because it does not explain the persistently low rate of real wage growth in the manufacturing sector. (In the latest year, the year to September 1988, real wages in manufacturing actually declined slightly). If emigration alone was creating a serious labour shortage then real wage growth might be expected to be rapid across all sectors of the economy. In this event, if a high rate of emigration persisted, in the longer run the growth rate of the economy would have to fall, except to the extent that labour productivity could be increased through substitution of capital for labour (which is difficult to achieve to any great extent in the service sector). Together with the pattern of real wage growth in manufacturing the rapid growth of total employment in the service sector and the maintenance of a strong overall economic growth rate over recent years (Chart 7) all suggest that this has not been occurring, at least so far.

A potentially more likely consequence of a loss of confidence in the future of Hong Kong is a large outflow of capital. Hong Kong has already been experiencing a net capital outflow since 1984 (see Chart 8), and it is likely that a part of this net capital outflow can be attributed to a reduced level of confidence on the part of residents (particularly in 1984, when uncertainty about the future of Hong Kong was at its height, ahead of the signing of the Sino-British agreement). Any massive outflow of capital resulting from a complete loss of confidence in Hong Kong would depress wages (particularly if the loss of confidence was also shared by foreigners). Asset prices would fall and interest rates would rise sharply as residents attempted to move capital out of Hong Kong. Through the mechanism of the linked exchange rate system Hong Kong would also experience a sharp monetary squeeze, which would slow the economy, reduce imports and bring down prices. The generalised deflation would then

HONG KONG: CHART 7
GROWTH OF REAL GDP



HONG KONG: CHART 8
BALANCE OF PAYMENTS



boost Hong Kong's competitiveness and lead to increased exports which, along with reduced imports, would help generate the current account surplus necessary to finance the net capital outflow. With greater international competitiveness and increased exports the economy's resources would be shifted to the export sector.

Although, in these circumstances, exports of services as well as manufactured products could be expected to increase, the manufacturing sector would grow at a more rapid rate than the service sector. (This is because the service sector as a whole is much less export oriented and also the demand for service sector exports is probably less price elastic than for manufactured exports and so would increase less as the economy deflated). Therefore the loss of capital from Hong Kong would tend to reverse the structural adjustment of the economy, shifting the economy back to a more manufacturing oriented economy. Nominal wages would be falling in all sectors but it would be likely that real wages would hold up better in the manufacturing sector than in the service sector.

It is evident that to date the capital outflow from Hong Kong has at no time been serious enough to hinder the structural adjustment process in this way. This, of course, does not mean that it could not become so at some time in the future. However, two caveats should be noted. Firstly, a loss of confidence in Hong Kong would only likely result in a deflation which would reverse the process of structural change in the economy if it was shared by foreigners as well as residents. If foreigners retained confidence in Hong Kong then the outflow of residents' capital would be at least partly financed by a gross inflow of foreigners' capital, as foreigners would be attracted by the higher yields on Hong Kong assets. This would reduce the need for a current account surplus to finance the gross capital outflow and lessen the deflationary tendencies on the economy. The longer-term result would merely be that a greater proportion of Hong Kong's assets would be owned by foreigners, a process which has already been taking place, to a certain extent. Secondly, and related to this, as time goes on the propensity of political shocks to have a deflationary impact on the economy will tend to diminish somewhat as ownership of assets in Hong Kong becomes more diversified between residents and foreigners.

The Impact of Structural Adjustment on Economic Variables.

As the structural adjustment of Hong Kong's economy proceeds during the 1990's, we should expect to see a continuing gradual increase in employment in the services sector and decline in employment in manufacturing. Accompanying this, real wage growth in the services sector is likely to remain higher than in manufacturing industry, reflecting the market forces encouraging the gradual movement of labour from manufacturing to services industries. The measured long-term growth rate of the economy might also tend to slow somewhat more than it has over the past twenty years (see Chart 7). Some decline in Hong Kong's natural rate of economic growth should anyway be expected as growth of the labour force slows or declines, and the economy becomes richer and consequently labour productivity increases more slowly. However, the movement to a more services-oriented economy should hasten this process because increases in labour productivity tend to be harder to achieve in the services industries as a whole than in manufacturing industry. To some extent,

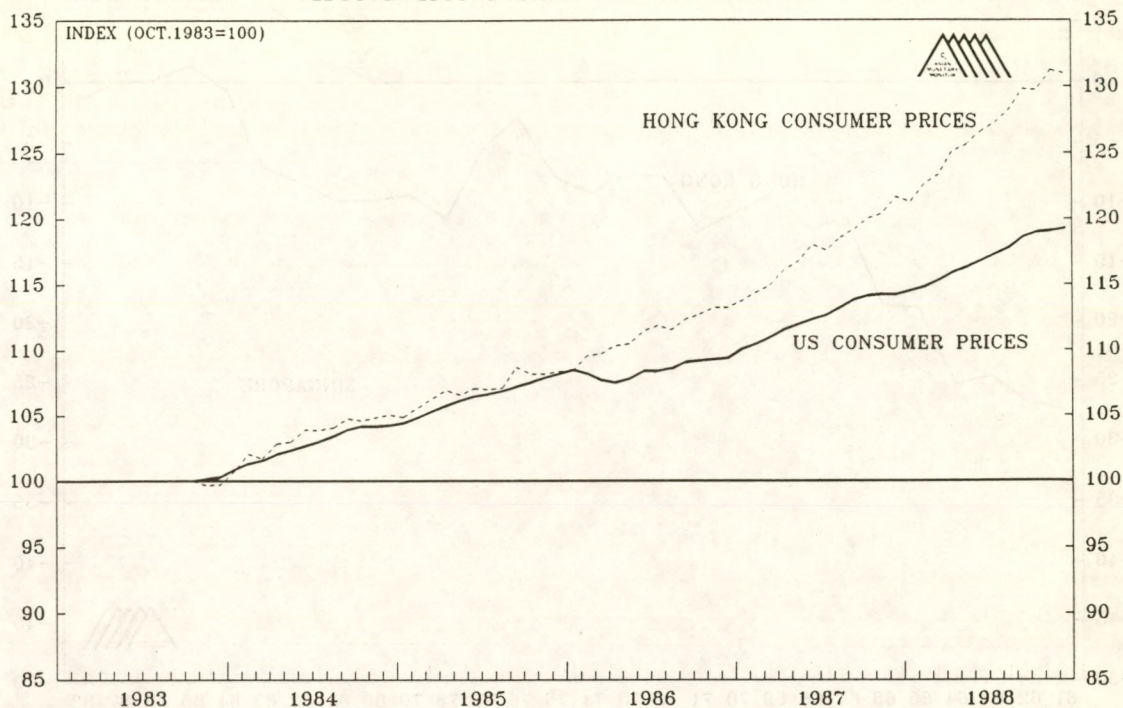
however, any decline in the rate of growth of Hong Kong's wealth from this source will be more apparent than real. The investments in China by Hong Kong enterprises, which are a primary stimulus to the structural change, will be generating income to Hong Kong residents offsetting the loss of real growth from the relative decline of manufacturing in Hong Kong. However, this income will not be captured in Hong Kong's national income statistics, which cover only gross domestic product (i.e. including only residents' income deriving from domestic economic activity and not including income derived from economic activity carried on abroad).

As long as the demand for services continues to grow rapidly the measured inflation rate for Hong Kong might tend to be somewhat higher than that for the U.S. This has been the pattern since 1986 (see Chart 9). The linked exchange rate system determines that prices of traded goods in Hong Kong should increase at the same rate as in the U.S., over the long term. Any tendency for generalised inflation in Hong Kong to be higher than in the U.S. should result in Hong Kong's products becoming less competitive and the trade account deteriorating. This puts downward pressure on monetary growth through the mechanism of the linked rate system until the inflation rates comes back into line. However, the constraint posed by the rate of price increases in the U.S. clearly applies less to the prices of services, which are less subject to the pressures of international competition. Therefore, as long as the demand for services continues to grow rapidly, to the extent that services prices form part of the consumer price index, the measured rate of inflation in Hong Kong could exceed that of the U.S., even over the longer term. Nevertheless, given that this would imply a continuous increase in the price of services relative to traded goods, a process to which there must be some limit in the short-term, the U.S. inflation rate should still provide an anchor to the measured inflation rate in Hong Kong, which should consequently not be expected to become too far out of line.

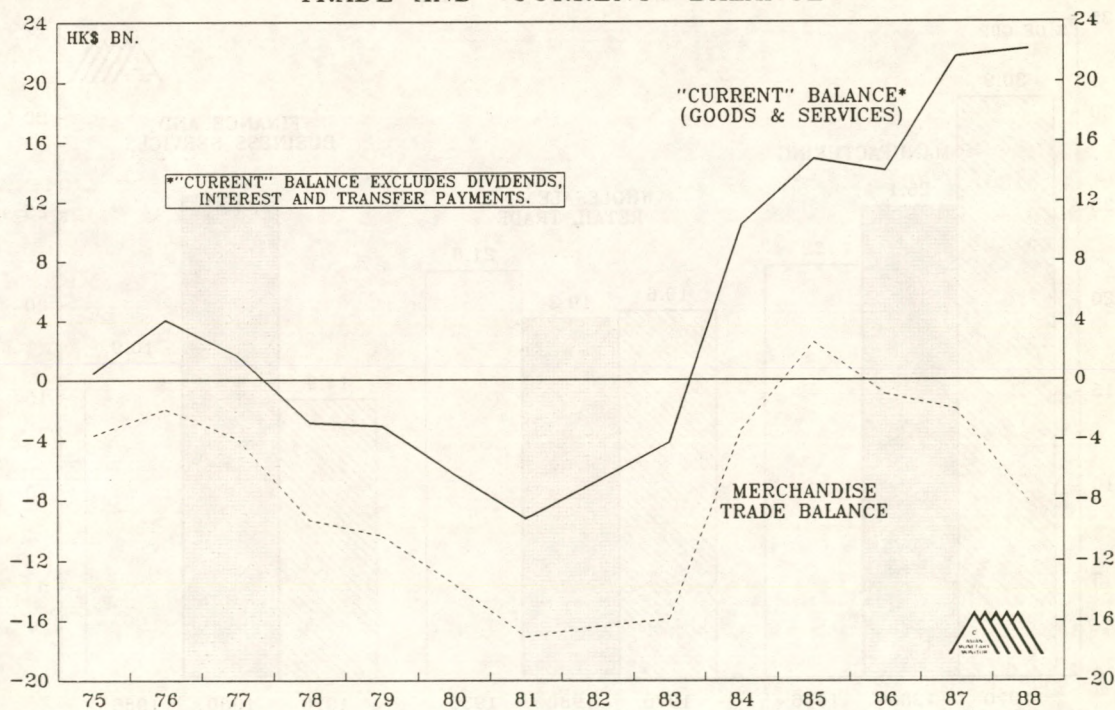
Possibly more significant is the likely impact on Hong Kong's trade balance. As a major force behind structural change in the Hong Kong economy is the growing demand for services from Hong Kong, it is necessarily the case that, over time, a growing proportion of the territory's foreign exchange earnings will derive from services, or invisibles (see Chart 10). Given that the current account always tends to balance in the long-run, as Hong Kong runs an increasingly large surplus in invisible trade (e.g. tourism, banking and financial services, possibly investment income) it must run an increasingly large deficit in visible, or merchandise trade. This would correspond with a trend decline in the importance of manufactured exports for Hong Kong as the manufacturing sector declines in relative importance. A growing trade deficit would essentially be the reverse of the trend which persisted through the 1960's and 1970's and into the mid-1980's, when Hong Kong's trade deficit gradually declined as a percentage of GDP (see Chart 11). This happened because, after the 1949 revolution in China, Hong Kong was effectively forced to give up its entrepot status to become a manufacturing centre. As services earnings for Hong Kong declined and the manufacturing sector grew in relative importance, Hong Kong's trade deficit narrowed and the surplus on invisible trade fell. This process should now go into reverse as Hong Kong resumes its entrepot role.

It should be noted that a long run trend to a growing trade deficit under

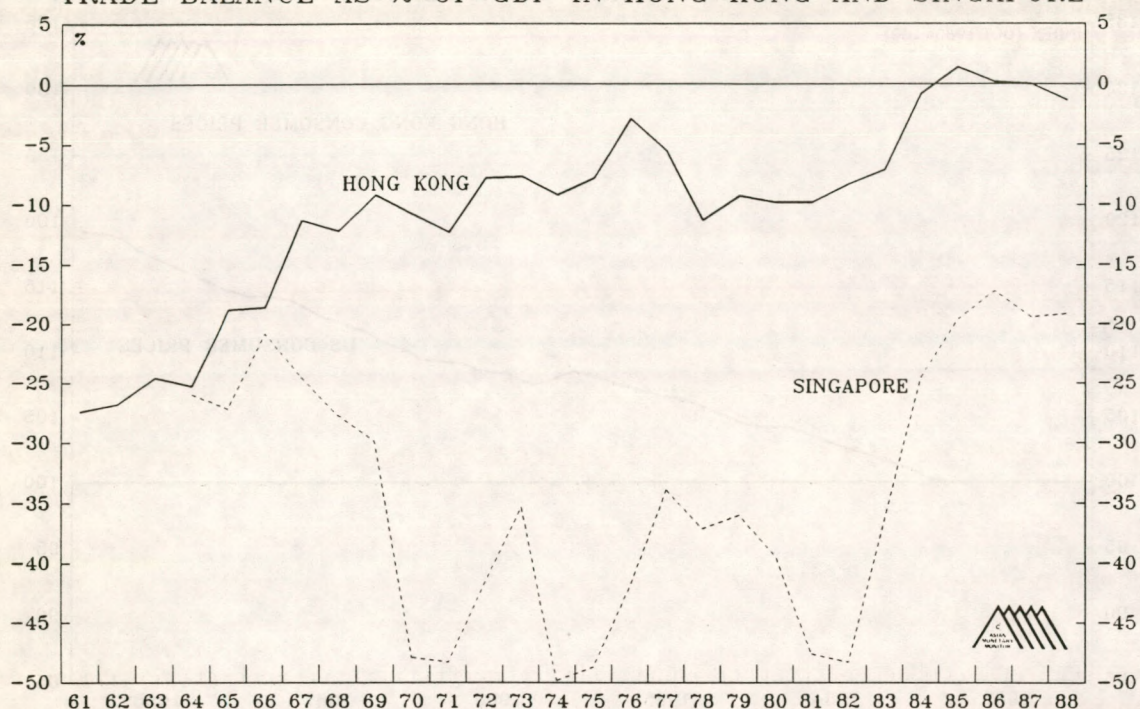
HONG KONG: CHART 9
HONG KONG AND US INFLATION



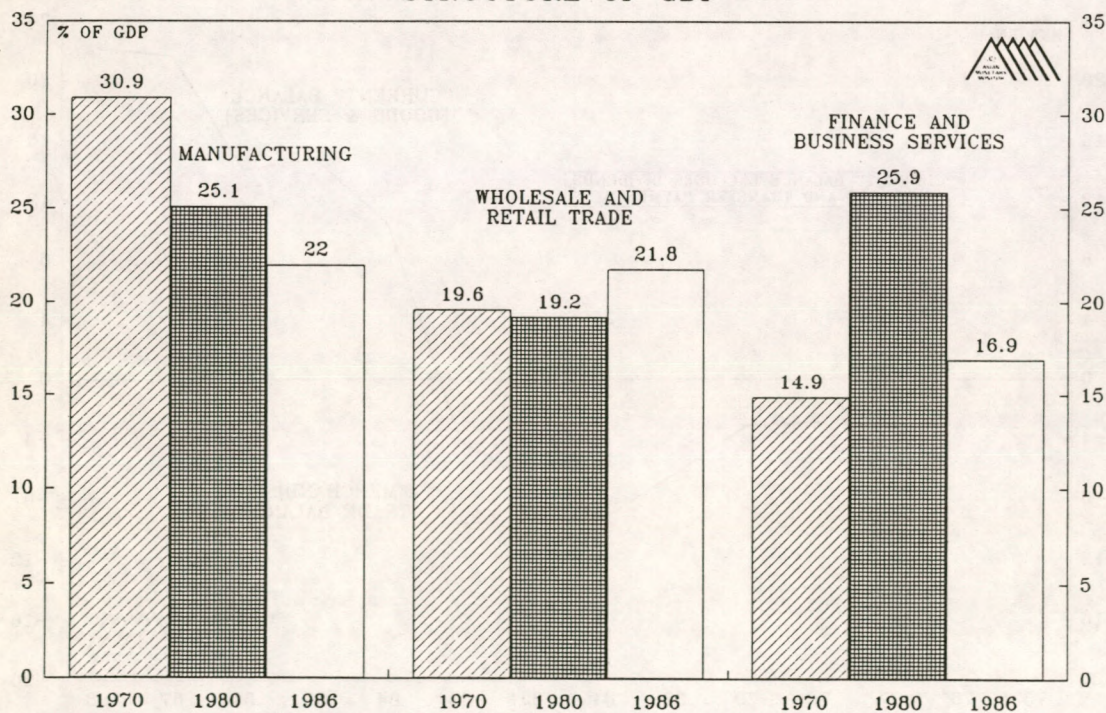
HONG KONG: CHART 10
TRADE AND "CURRENT" BALANCE



HONG KONG: CHART 11
TRADE BALANCE AS % OF GDP IN HONG KONG AND SINGAPORE



HONG KONG: CHART 12
STRUCTURE OF GDP



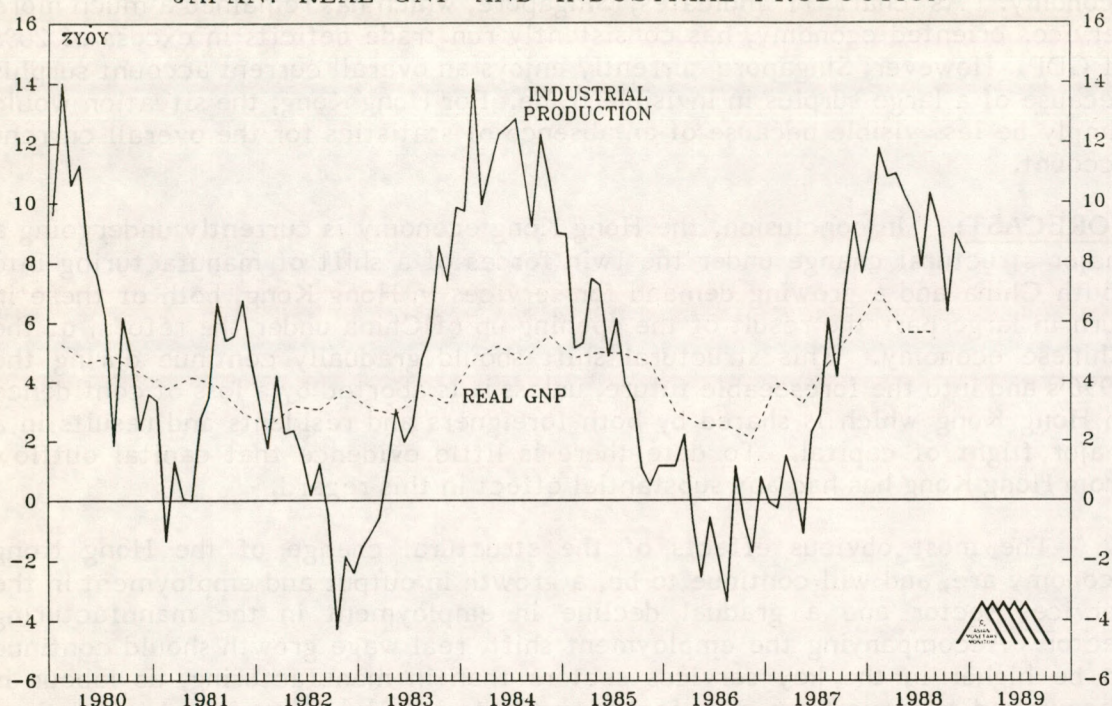
these circumstances would in no sense constitute a 'problem' for Hong Kong's economy. As chart 11 indicates, Singapore, which has remained a much more services oriented economy, has consistently run trade deficits in excess of 20% of GDP. However, Singapore currently enjoys an overall current account surplus because of a large surplus in invisible trade. For Hong Kong, the situation would simply be less visible because of an absence of statistics for the overall current account.

FORECAST: In conclusion, the Hong Kong economy is currently undergoing a major structural change under the twin forces of a shift of manufacturing into south China and a growing demand for services in Hong Kong, both of these in turn in large part the result of the opening up of China under the reform of the Chinese economy. This structural shift should gradually continue during the 1990's and into the foreseeable future, unless it is aborted by a loss of confidence in Hong Kong which is shared by both foreigners and residents and results in a major flight of capital. To date there is little evidence that capital outflow from Hong Kong has had any substantial effect in this regard.

The most obvious effects of the structural change of the Hong Kong economy are, and will continue to be, a growth in output and employment in the services sector and a gradual decline in employment in the manufacturing sector. Accompanying the employment shift, real wage growth should continue to be higher in the key services sectors than in manufacturing, as labour is encouraged to move from manufacturing to the service industries. Less obvious effects of the ongoing structural change are likely to be a long-run trend to a growing merchandise trade deficit, reflecting the fact that a greater proportion of Hong Kong's foreign exchange earnings will derive from invisibles, and a somewhat lower trend rate of growth of gross domestic product, because a larger part of growth in national income for the territory will be attributable to income from overseas investments and operations of Hong Kong enterprises, including those within China. Hong Kong's measured consumer price inflation rate might remain somewhat higher than the U.S. inflation rate, despite the exchange rate link, because of price rises in services less subject to the pressures of international competition. Nevertheless, particularly if occurring together, these long-run trends of higher wage growth in the services sector, a larger trade deficit, a slower GDP growth rate, and a comparatively high inflation rate need not be seen as adverse developments or as symptoms of underlying problems in the Hong Kong economy. Rather they should be seen as evidence of the upgrading of the economy into one based more on services than manufacturing production.

JAPAN: NO SIGNS OF AN IMMINENT PICK-UP IN INFLATION

JAPAN: REAL GNP AND INDUSTRIAL PRODUCTION

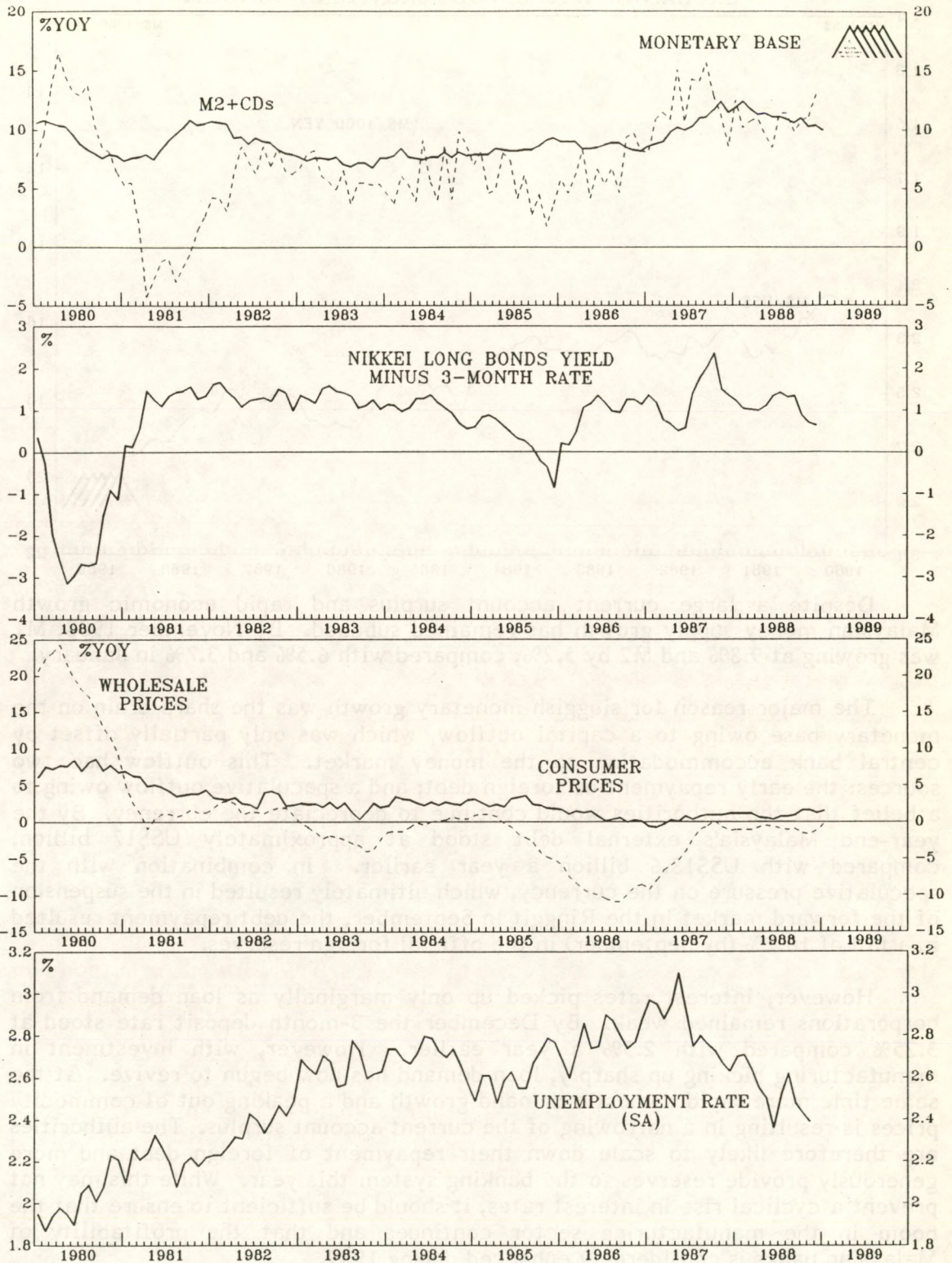


With movements in the Japanese long bond assuming greater importance to investors, increasing attention is being focused on the outlook for inflation. Despite rapid economic growth - real GNP grew by an estimated 5.9% during 1988 - and tightening labour markets there are, as yet, few signs of rising inflation. In the year to January consumer prices rose by 1.1% but wholesale prices fell by 0.1%. A number of indicators including the somewhat more restrained monetary policy stance, ongoing deregulation which is enhancing the productive potential of the economy, and the likelihood that commodity prices are close to peaking, all point to inflation remaining subdued in the immediate months ahead.

The slowdown in the growth of M2 plus CDs from a peak of 12.4% last February to 10% currently probably overstates the degree to which monetary policy has been tightened, owing to the distorting impact of the abolition of Maruyu. However, another indicator, the shape of the yield curve, does point to a slight tightening over the last year (see chart). This has occurred against the background of an economy, which on IMF estimates, has a productive potential of between 4.0% and 4.5%, a range which was not exceeded by too wide a margin during 1988. Furthermore, as estimates of productive potential assume a static policy framework, which has not been the case for Japan given the rapid deregulation that has occurred, last year's growth rate probably fell within, or was not too far above, the actual potential of the economy.

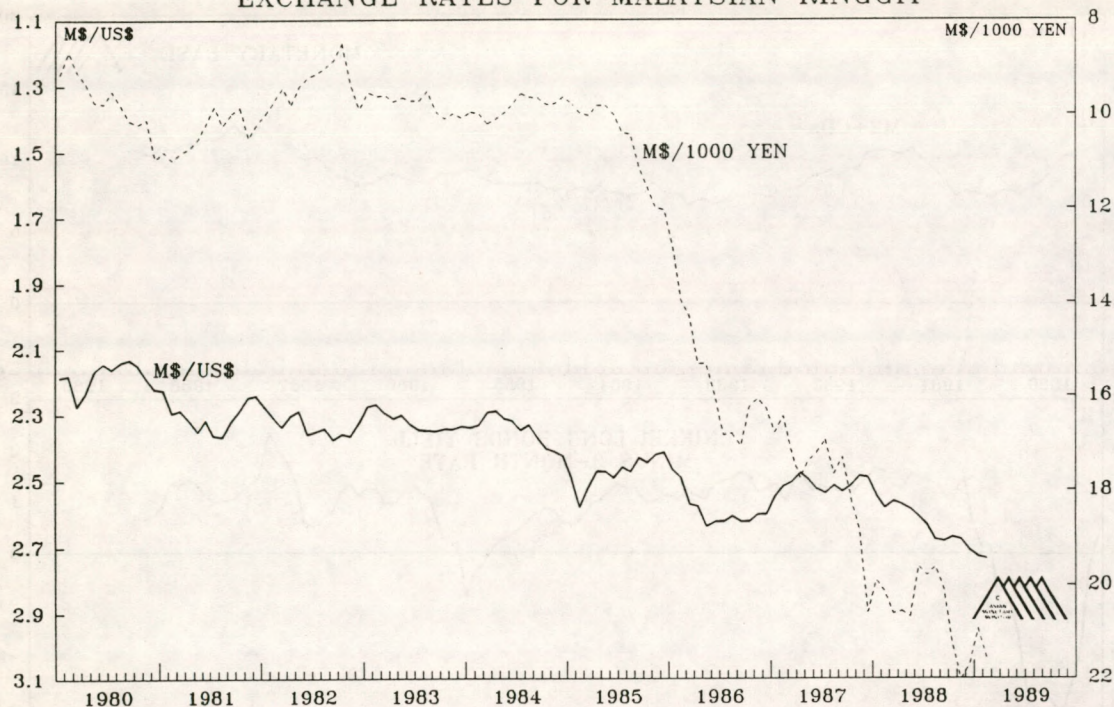
Notwithstanding these arguments the measured inflation rate is likely to trend up somewhat in the coming months. The imposition of a 3% indirect tax on 1 April is likely to add about 1.5% to the consumer price index, which will only be partially offset by a simultaneous reduction in electricity tariffs.

JAPAN MONETARY POLICY INDICATORS



MALAYSIA: MONETARY GROWTH SET TO RISE

EXCHANGE RATES FOR MALAYSIAN RINGGIT

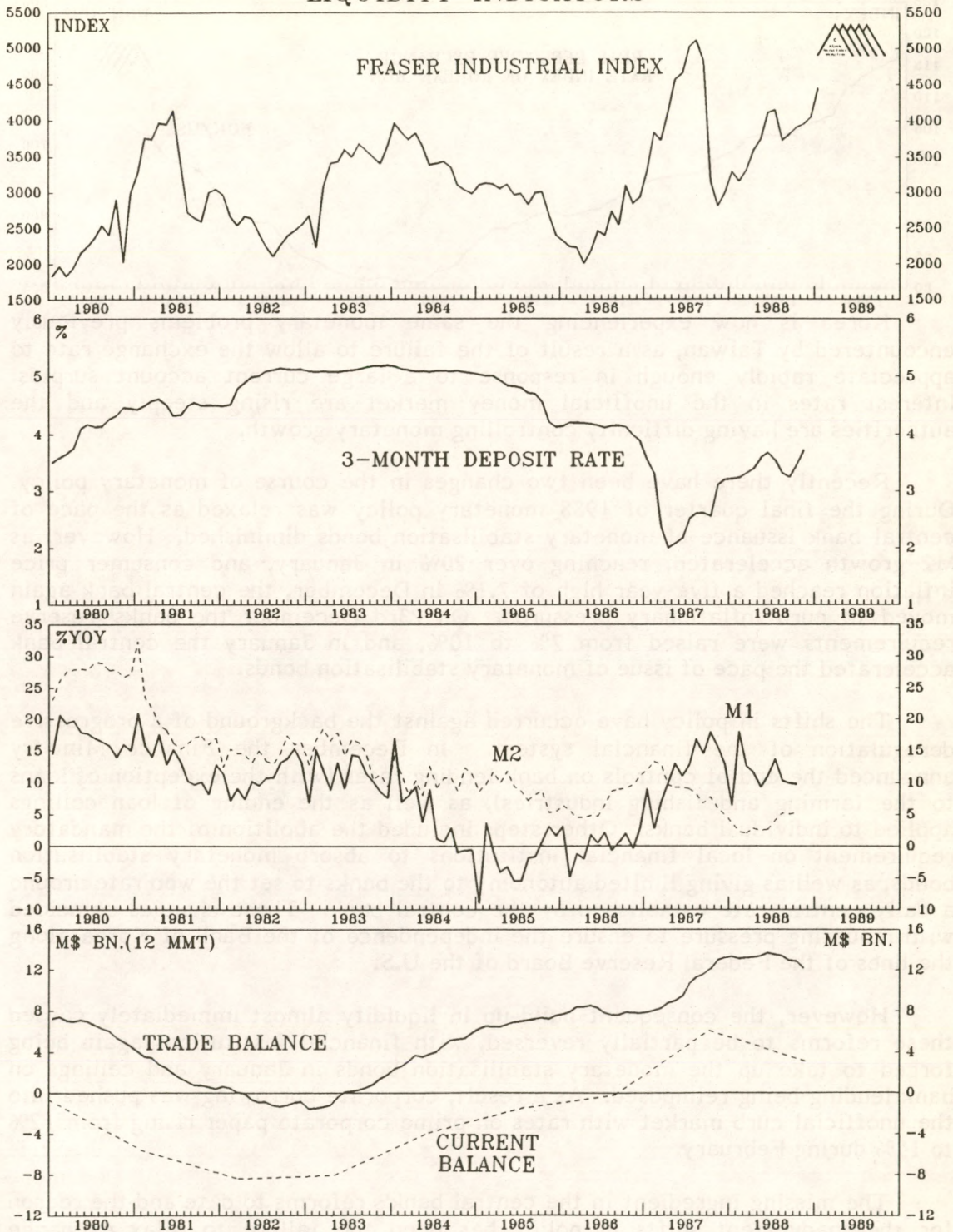


Despite a large current account surplus and rapid economic growth Malaysian money supply growth has remained subdued. By November 1988, M1 was growing at 9.8% and M2 by 5.2%, compared with 6.5% and 3.7% in January.

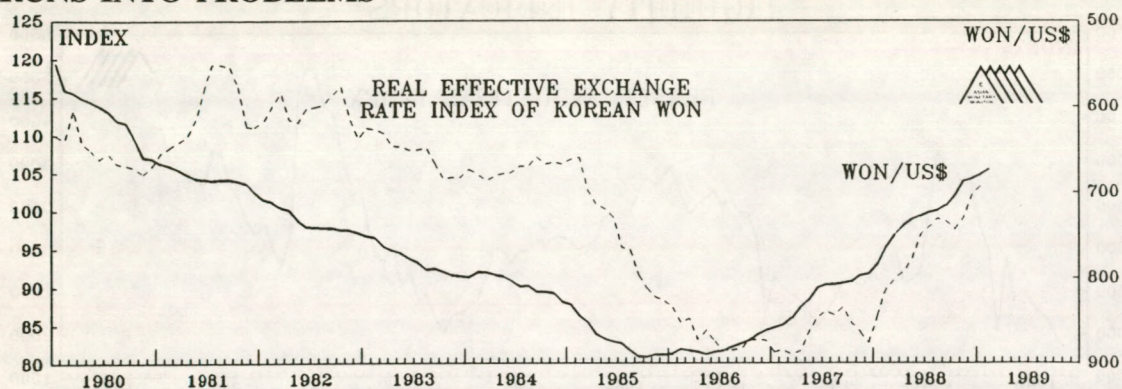
The major reason for sluggish monetary growth was the sharp drain on the monetary base owing to a capital outflow, which was only partially offset by central bank accommodation to the money market. This outflow had two sources: the early repayment of foreign debt; and a speculative outflow owing to a belief that the authorities would continue to depreciate the currency. By the year-end Malaysia's external debt stood at approximately US\$17 billion, compared with US\$18.6 billion a year earlier. In combination with the speculative pressure on the currency, which ultimately resulted in the suspension of the forward market in the Ringgit in September, the debt repayment resulted in a fall of 10.2% (by September) in the official foreign reserves.

However, interest rates picked up only marginally as loan demand from corporations remained weak. By December the 3-month deposit rate stood at 3.25% compared with 2.5% a year earlier. However, with investment in manufacturing picking up sharply, loan demand has now begun to revive. At the same time more rapid domestic demand growth and a peaking out of commodity prices is resulting in a narrowing of the current account surplus. The authorities are therefore likely to scale down their repayment of foreign debt and more generously provide reserves to the banking system this year. While this may not prevent a cyclical rise in interest rates, it should be sufficient to ensure that the boom in the manufacturing sector continues and that the profitability of Malaysian banks is considerably enhanced during 1989.

MALAYSIA LIQUIDITY INDICATORS



SOUTH KOREA: DEREGULATION OF THE FINANCIAL SYSTEM RUNS INTO PROBLEMS



Korea is now experiencing the same monetary problems previously encountered by Taiwan, as a result of the failure to allow the exchange rate to appreciate rapidly enough in response to a large current account surplus. Interest rates in the unofficial money market are rising steeply and the authorities are having difficulty controlling monetary growth.

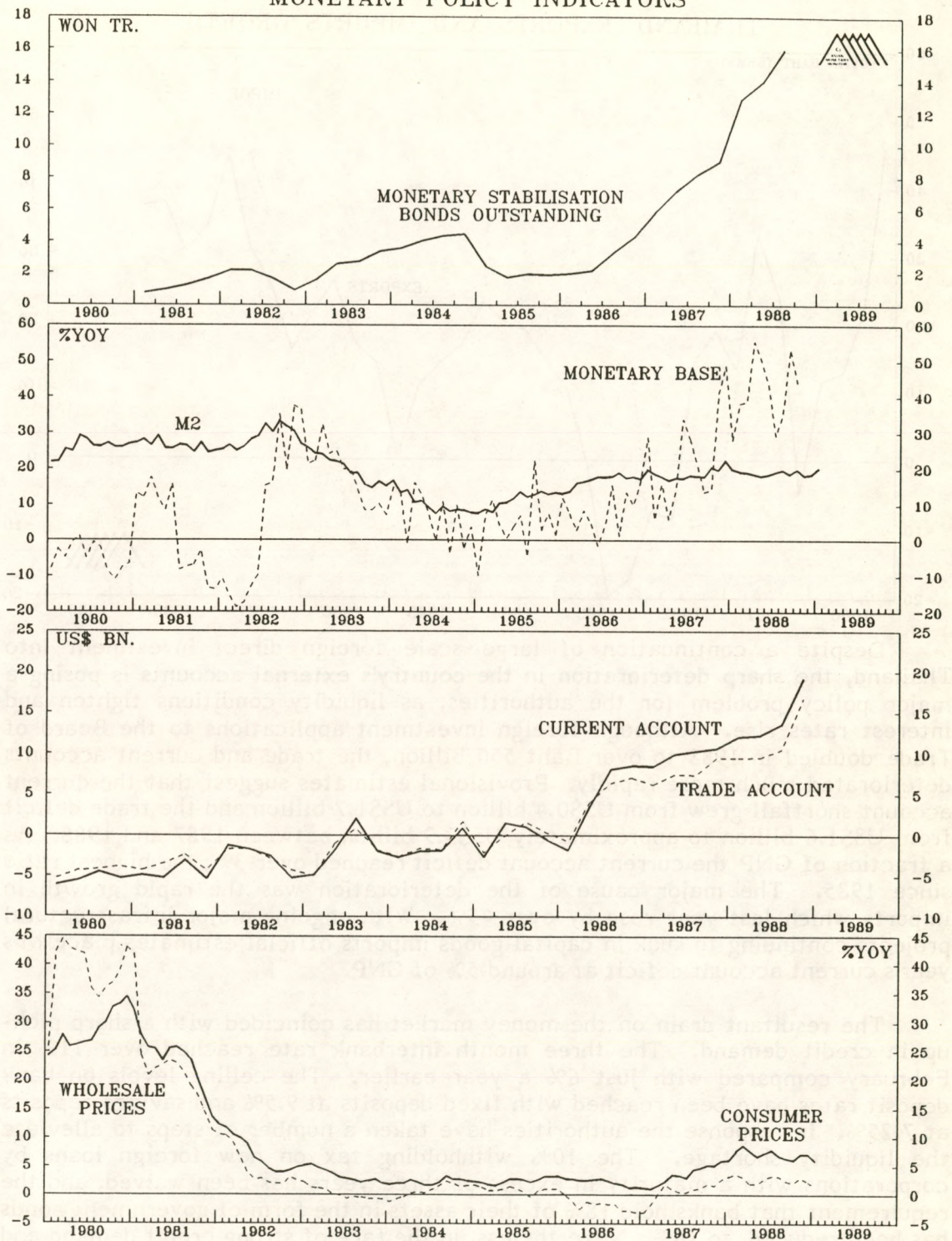
Recently there have been two changes in the course of monetary policy. During the final quarter of 1988 monetary policy was relaxed as the pace of central bank issuance of monetary stabilisation bonds diminished. However, as M2 growth accelerated, reaching over 20% in January, and consumer price inflation reached a five year high of 7.1% in December, the central bank again moved to curb inflationary pressures. On 23rd December the banks' reserve requirements were raised from 7% to 10%, and in January the central bank accelerated the pace of issue of monetary stabilisation bonds.

The shifts in policy have occurred against the background of a progressive deregulation of the financial system. In December the Finance Ministry announced the end of controls on bank lending rates (with the exception of loans to the farming and fishing industries), as well as the ending of loan ceilings applied to individual banks. Other steps included the abolition of the mandatory requirement on local financial institutions to absorb monetary stabilisation bonds, as well as giving limited autonomy to the banks to set the won rate around a daily central rate established by the central bank. These changes coincided with mounting pressure to ensure the independence of the Bank of Korea along the lines of the Federal Reserve Board of the U.S.

However, the consequent build-up in liquidity almost immediately caused these reforms to be partially reversed, with financial institutions again being forced to take up the monetary stabilisation bonds in January and ceilings on bank lending being reimposed. As a result, corporate borrowing was pushed into the unofficial curb market with rates on prime corporate paper rising from 12% to 15% during February.

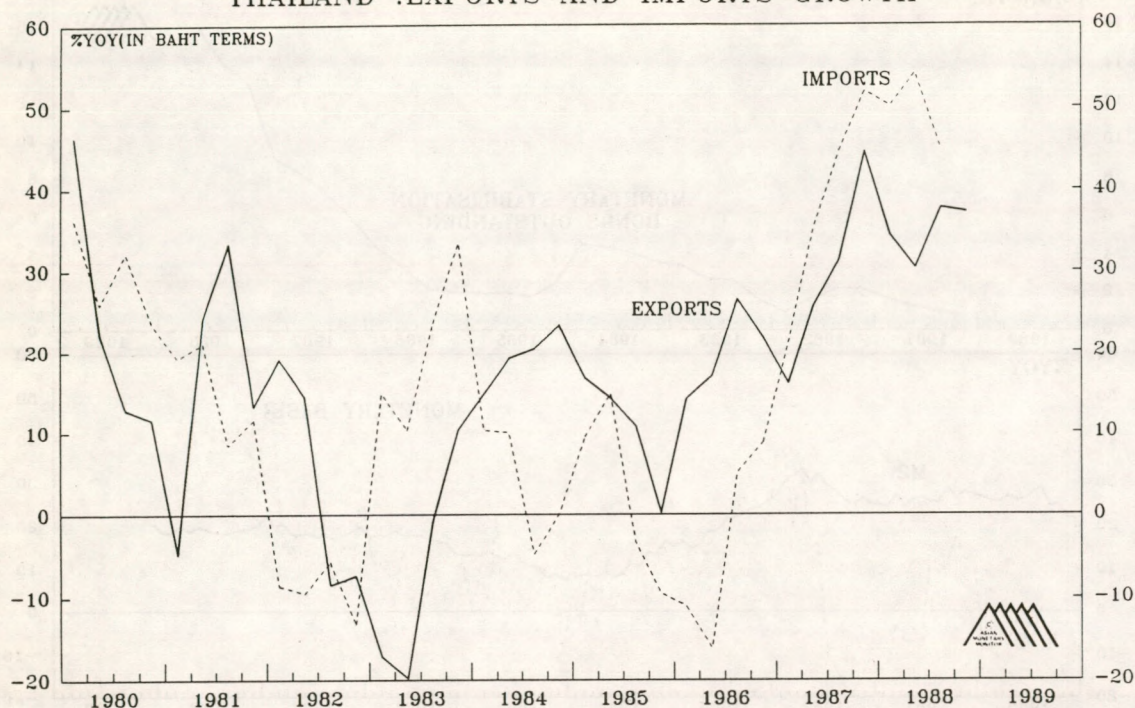
The missing ingredient in the central bank's reforms to date and the reason for the inadvertent shifts in policy has been the failure to relax exchange controls or allow faster appreciation of the currency. Although the won gained by 13.6% in the year to February it still remains substantially undervalued on a purchasing power parity basis, especially given that the current account surplus, which in 1988 reached over US\$14 billion, is still widening.

THE REPUBLIC OF KOREA MONETARY POLICY INDICATORS



THAILAND: INTEREST RATES RISE AS TRADE DEFICIT DETERIORATES.

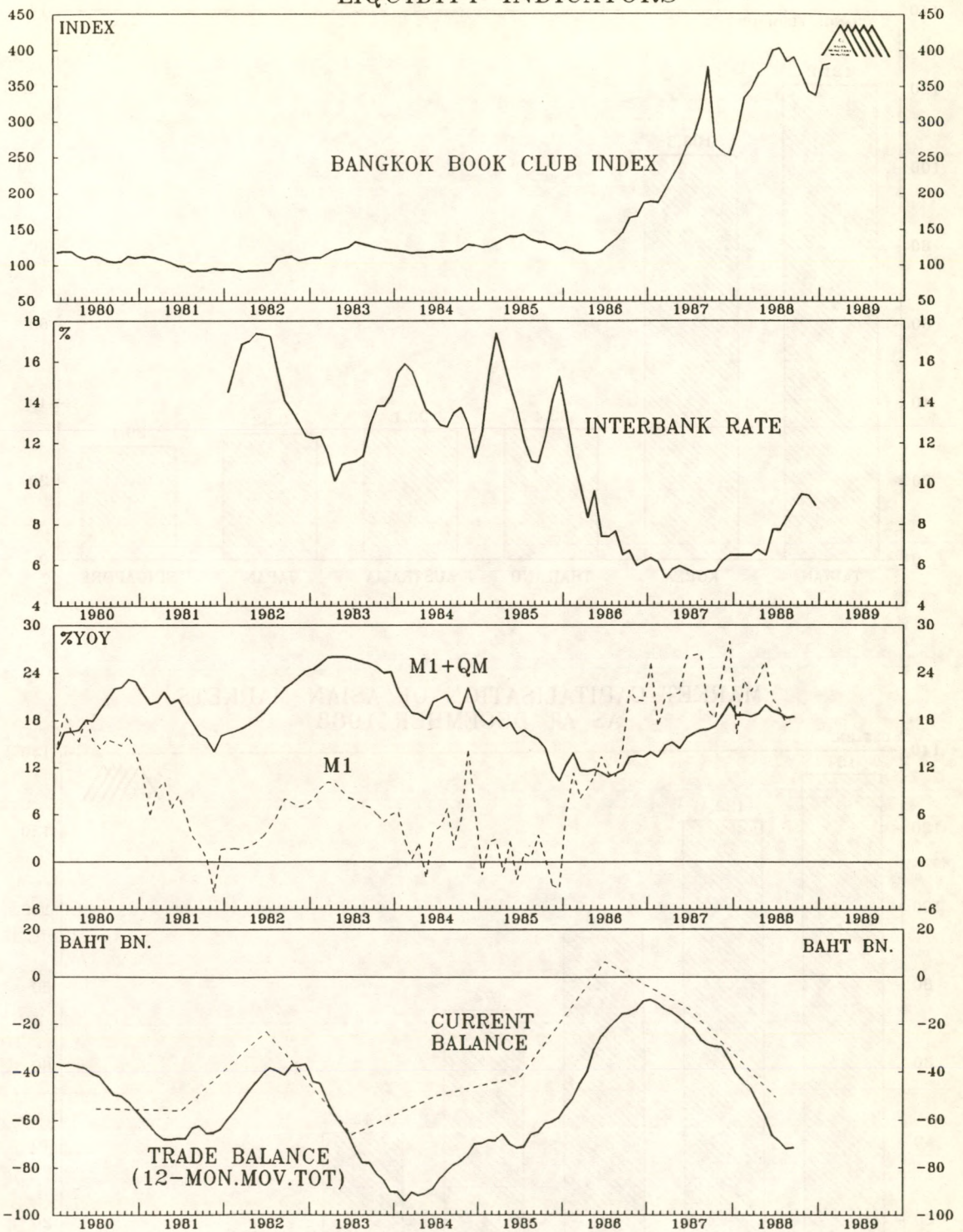
THAILAND :EXPORTS AND IMPORTS GROWTH



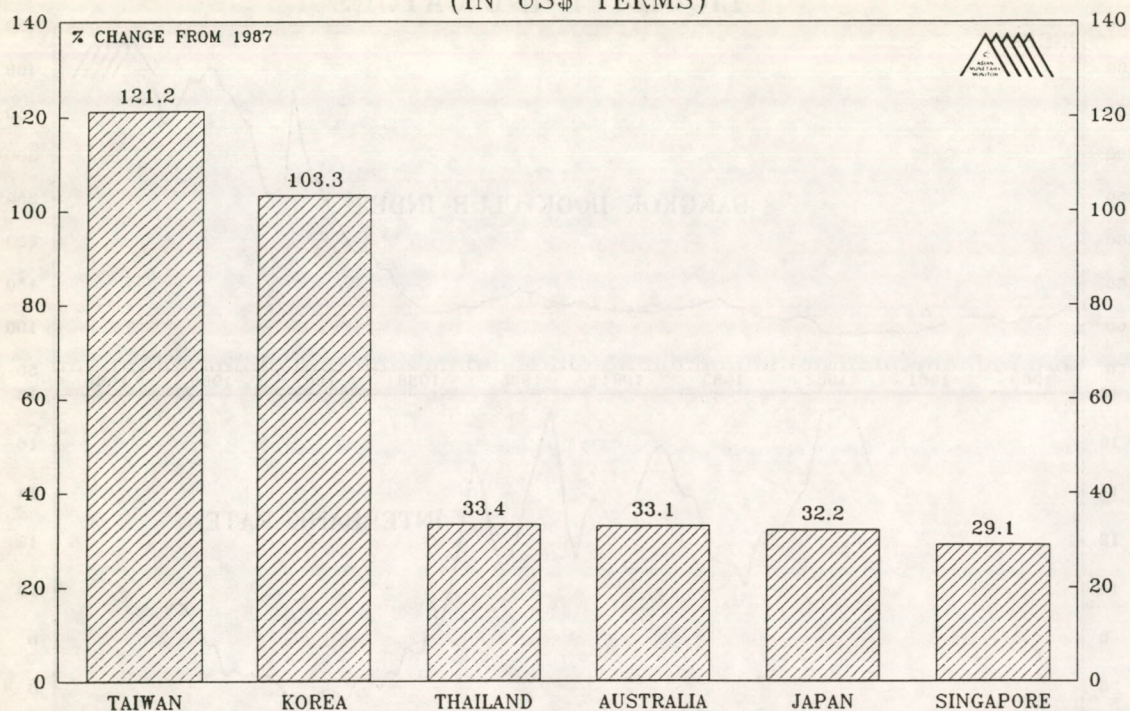
Despite a continuation of large scale foreign direct investment into Thailand, the sharp deterioration in the country's external accounts is posing a major policy problem for the authorities, as liquidity conditions tighten and interest rates rise. Although foreign investment applications to the Board of Trade doubled in 1988 to over Baht 550 billion, the trade and current accounts deteriorated much more rapidly. Provisional estimates suggest that the current account shortfall grew from US\$0.4 billion to US\$1.7 billion and the trade deficit from US\$1.6 billion to approximately US\$3.9 billion between 1987 and 1988. As a fraction of GNP the current account deficit reached over 3%, the highest ratio since 1985. The major cause of the deterioration was the rapid growth in imports which last year rose by over 45%. With ongoing major infrastructural projects continuing to suck in capital goods imports official estimates place this year's current account deficit at around 5% of GNP.

The resultant drain on the money market has coincided with a sharp pick-up in credit demand. The three month interbank rate reached over 11% in February compared with just 6% a year earlier. The ceiling levels on bank deposit rates have been reached with fixed deposits at 9.5% and savings deposits at 7.25%. In response the authorities have taken a number of steps to alleviate the liquidity shortage. The 10% withholding tax on new foreign loans by corporations with a maturity in excess of three years has been waived, and the requirement that banks hold 18% of their assets in the form of government bonds has been reduced, to 16%. Nevertheless, in the face of strong credit demand and a growing current account shortfall it seems inevitable that the authorities will be forced to raise the ceilings on both deposit and lending rates as interest rates climb further during 1989.

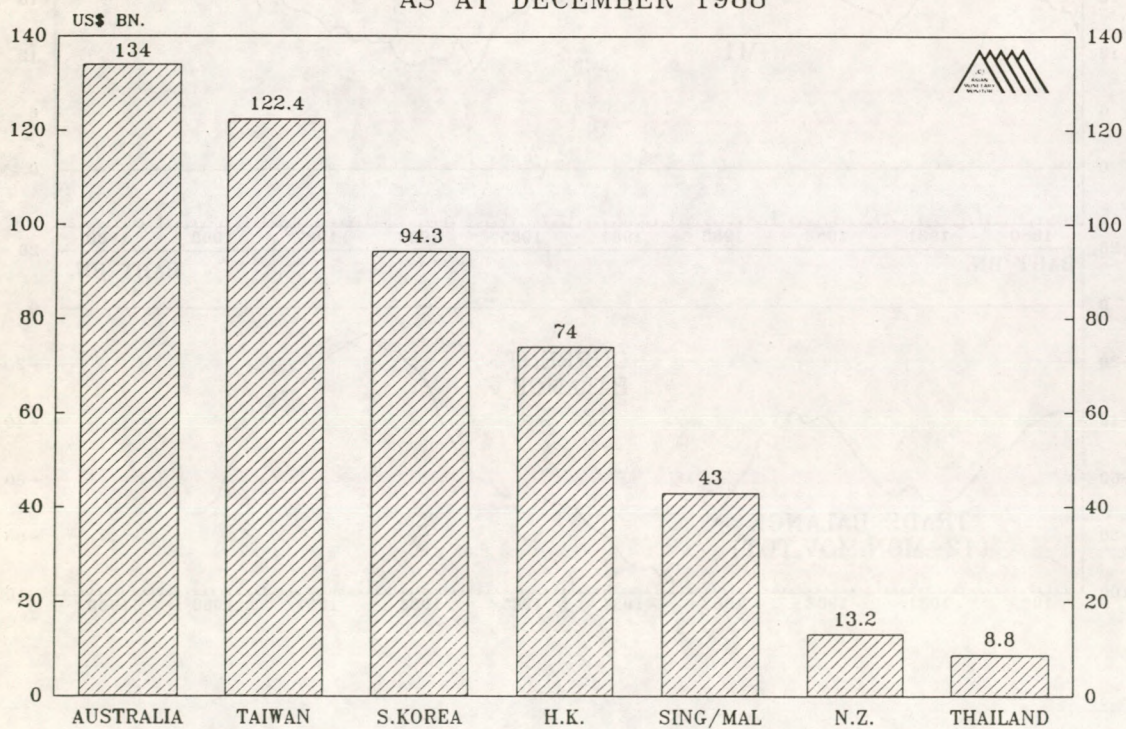
THAILAND LIQUIDITY INDICATORS



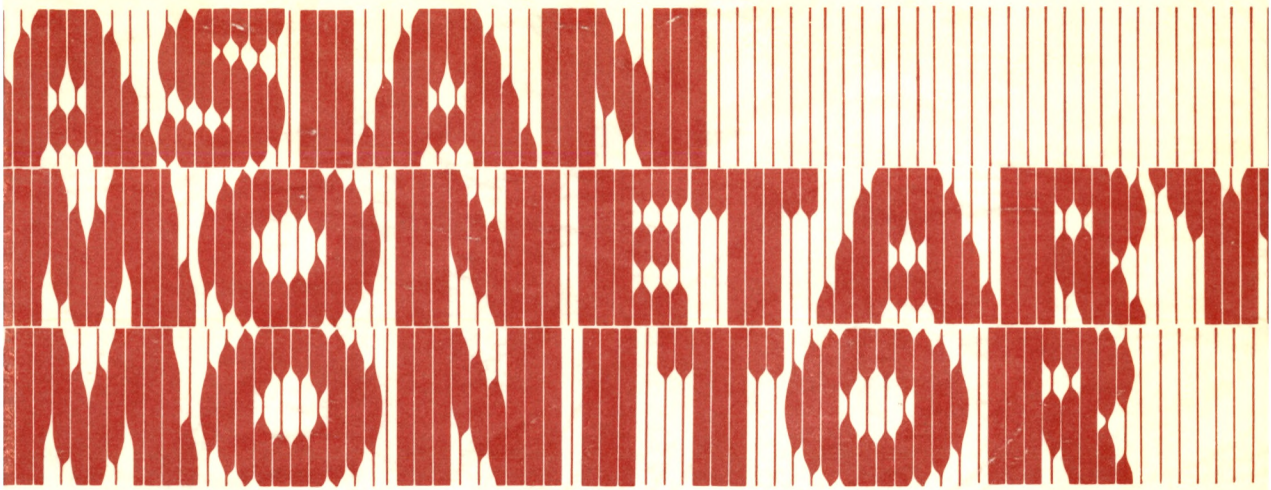
SIX BEST PERFORMING ASIAN STOCKMARKETS IN 1988 (IN US\$ TERMS)



MARKET CAPITALISATION OF ASIAN MARKETS AS AT DECEMBER 1988





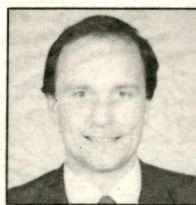


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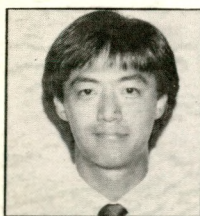
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JAPAN: PROSPECTS FOR THE DOMESTIC DEMAND-LED EXPANSION

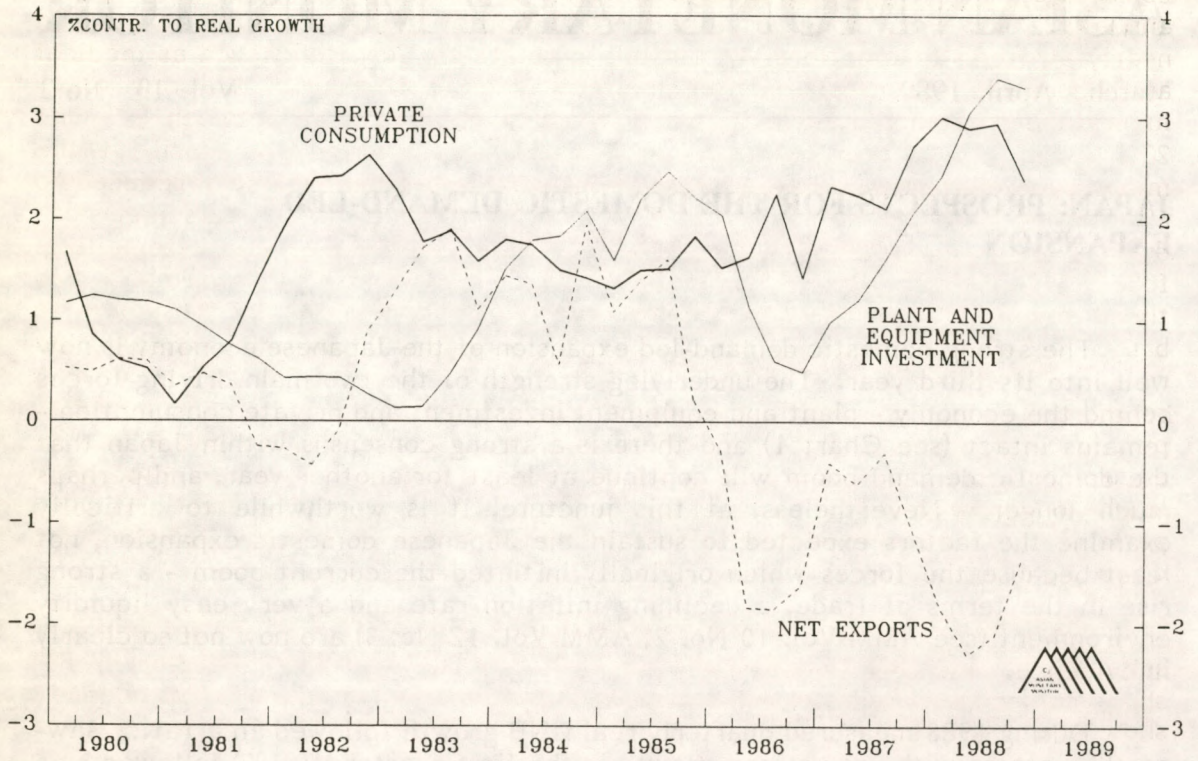
The strong domestic demand-led expansion of the Japanese economy is now well into its third year. The underlying strength of the two main driving forces behind the economy - plant and equipment investment and private consumption - remains intact (see Chart 1) and there is a strong consensus within Japan that the domestic demand boom will continue at least for another year, and perhaps much longer. Nevertheless, at this juncture, it is worthwhile to critically examine the factors expected to sustain the Japanese domestic expansion, not least because the forces which originally initiated the current boom - a strong rise in the terms of trade, a declining inflation rate and a very easy liquidity environment (see AMM Vol. 10 No. 2, AMM Vol. 12 No. 3) are now not so clearly in evidence.

During 1988 measured quarterly real GNP growth followed an erratic, 'saw-tooth', pattern with very strong growth in the first quarter (10.1%) followed by a contraction in the second quarter (-3.3%) and a very strong rebound in the third quarter (9.5%) followed again by weaker growth in the final quarter (3.0%). Nevertheless by later 1988 growth in the economy had clearly slowed somewhat from the unsustainable pace of the latter half of 1987 and early 1988 when the growth rate was in excess of 7% for three successive quarters. Measured on the basis of half yearly periods growth in domestic demand for the second half of the year was 5.2%, still a very strong rate of growth but down from the 8.8% rate achieved for the first half. In the fourth quarter alone domestic demand grew at an annualised rate of only 3.1%, with consumer spending flat in real terms.

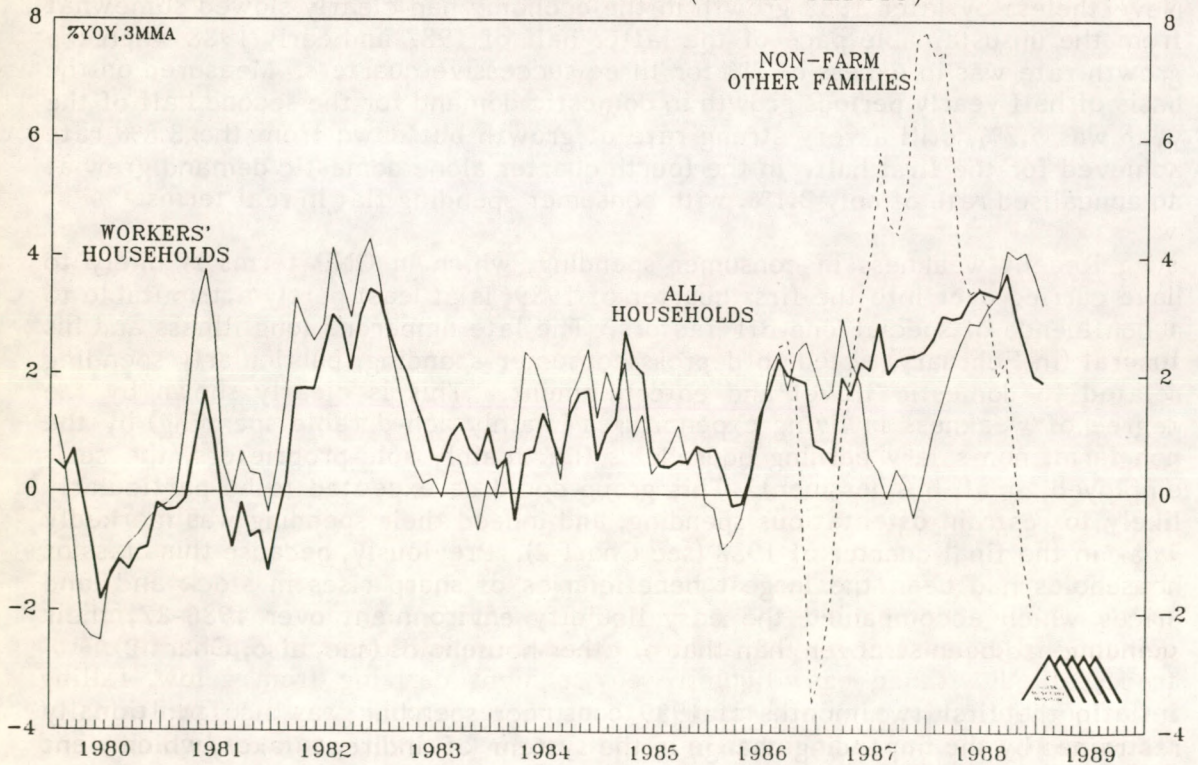
Recent weakness in consumer spending, which in GNP terms is likely to have carried over into the first quarter of 1989, is at least partly attributable to a confluence of special 'one-off' factors. The late emperor's long illness and his funeral (in February) acted to depress consumer spending, particularly spending related to domestic travel and entertainment. This is clearly shown by the degree of weakness in living expenditures (mainly non-durable spending) by the non-farm, non-salary earning households (i.e. mainly sole-proprietors, the self-employed, small businessmen). This group could be expected to be particularly likely to restrain ostentatious spending, and indeed their spending was markedly weak in the final quarter of 1988 (see Chart 2). Previously, because this class of households had been the largest beneficiaries of sharp rises in stock and land prices which accompanied the easy liquidity environment over 1986-87, their spending had been stronger than that of other households (see, also, Chart 2).

In the first two months of 1989 consumer spending was also additionally restrained by the impending change in the system of indirect taxes, which went

JAPAN: CHART 1
GROWTH OF GNP COMPONENTS



JAPAN: CHART 2
LIVING EXPENDITURES (REAL TERMS)



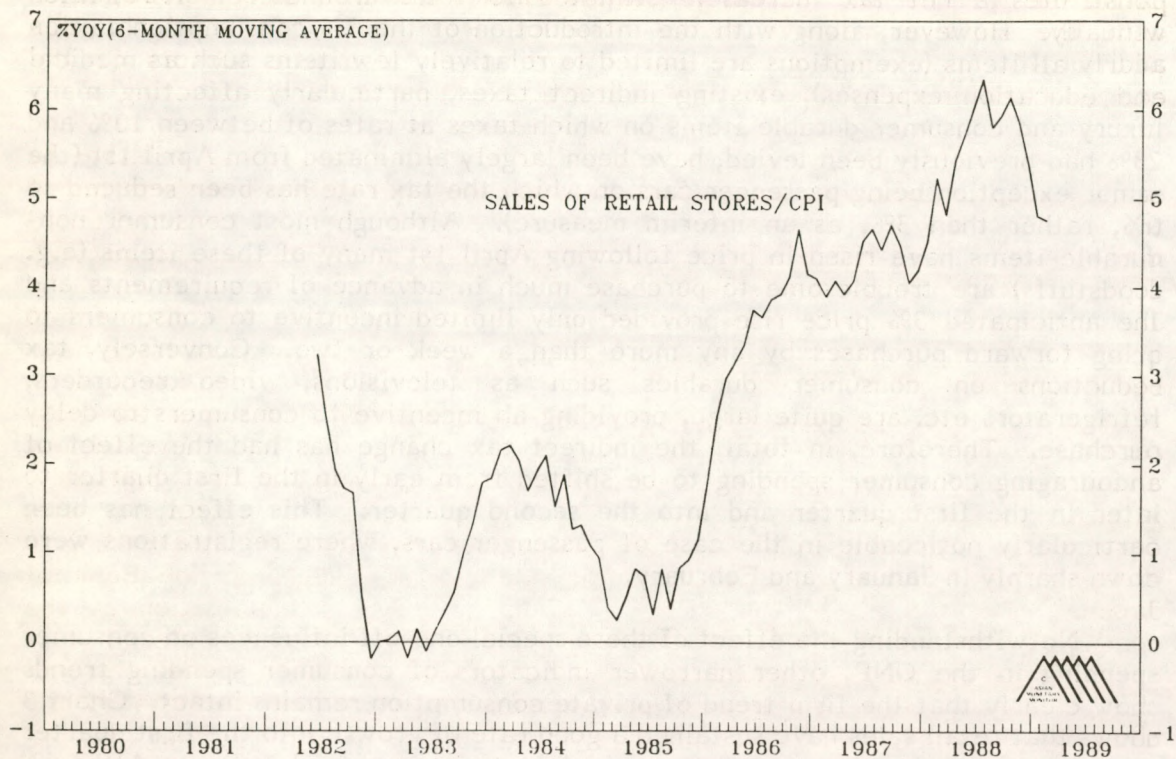
into effect on April 1st. The change in the indirect tax system in itself constitutes a net tax increase, estimated to total around Yen 1.5 trillion annually. However, along with the introduction of the 3% consumption tax on nearly all items (exemptions are limited to relatively few items such as medical and education expenses), existing indirect taxes, particularly affecting many luxury and consumer durable items on which taxes at rates of between 10% and 23% had previously been levied, have been largely eliminated from April 1st (the minor exception being passenger cars on which the tax rate has been reduced to 6%, rather than 3%, as an interim measure). Although most consumer non-durable items have risen in price following April 1st many of these items (e.g. foodstuffs) are troublesome to purchase much in advance of requirements and the anticipated 3% price rise provided only limited incentive to consumers to bring forward purchases by any more than a week or two. Conversely, tax reductions on consumer durables such as televisions, video recorders, refrigerators etc. are quite large, providing an incentive to consumers to delay purchase. Therefore, in total, the indirect tax change has had the effect of encouraging consumer spending to be shifted from early in the first quarter to later in the first quarter and into the second quarter. This effect has been particularly noticeable in the case of passenger cars, where registrations were down sharply in January and February.

Notwithstanding the effect of these special one-off influences on consumer spending in the GNP, other narrower indicators of consumer spending trends show clearly that the firm trend of private consumption remains intact. Chart 3 shows that retail sales have sustained a good rate of growth into the first quarter of 1989. In addition, import volume growth has remained fairly strong. Although Japan's current account surplus has been on a rising trend over the past six months this has been primarily due to a recovery in exports growth, as well as weakness in oil prices (until recently). Volumes of imports of goods and services measured on the GNP basis grew at 21.7% in the second half of 1988, marginally exceeding the growth rate recorded in the first half of the year.

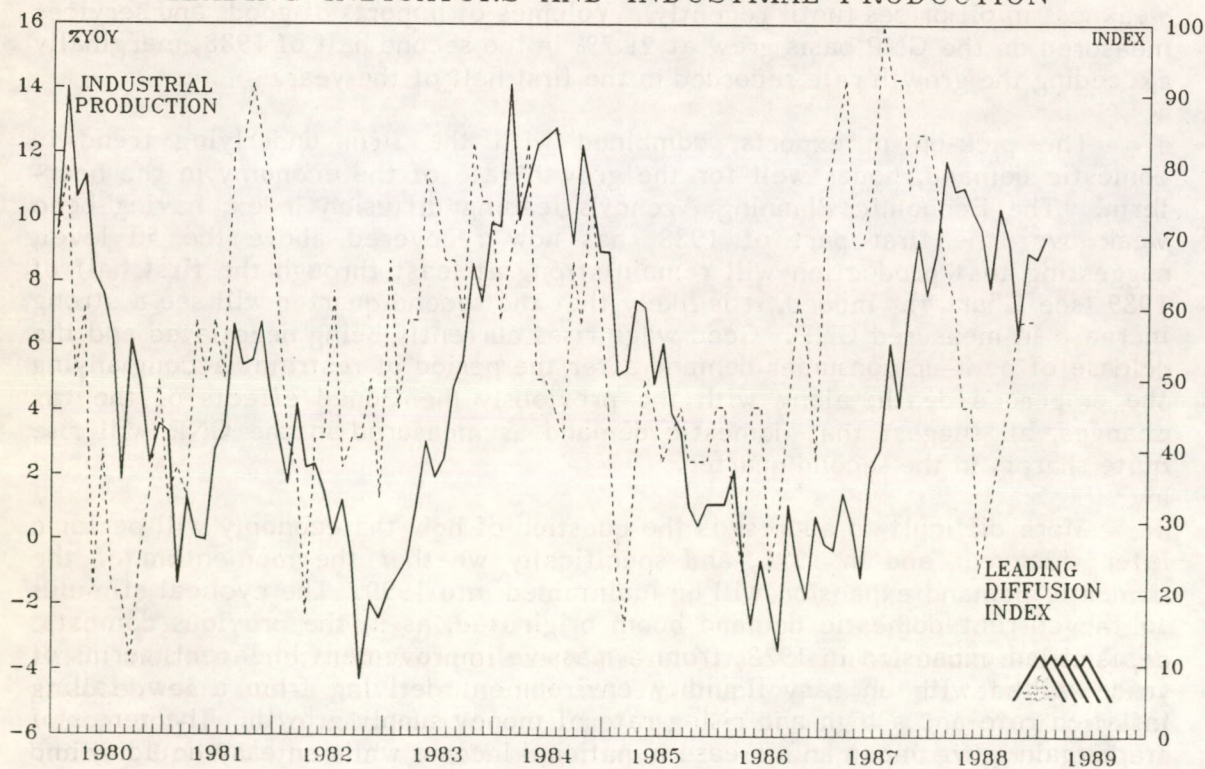
The pick-up in exports, combined with the firm underlying trend in domestic demand, bodes well for the growth rate of the economy in the near-term. The Economic Planning Agency's leading diffusion index, having been weak over the first part of 1988, has now recovered above the 50 level, suggesting that production will remain strong at least through the first half of 1989 (see Chart 4). Indeed, it is likely that the second quarter will see a strong increase in measured GNP. Good wage rises currently being negotiated and the release of pent-up consumer demand after the period of restraint accompanying the emperor's death, along with the previously mentioned effects of the tax changes, all suggest that domestic demand as measured in the GNP will rise quite sharply in the second quarter.

More difficult to address is the question of how the economy will perform later this year and in 1990, and specifically whether the momentum of the domestic demand expansion will be maintained into 1990. The cyclical stimulus to the current domestic demand boom originated, as in the previous domestic demand-led expansion in 1978, from a massive improvement in Japan's terms of trade, allied with an easy liquidity environment deriving from a low, falling inflation rate and a high and rising rate of money supply growth. The terms of trade gain gave Japan an increase in national income while an easy liquidity and

JAPAN: CHART 3 REAL RETAIL SALES



JAPAN: CHART 4 LEADING INDICATORS AND INDUSTRIAL PRODUCTION



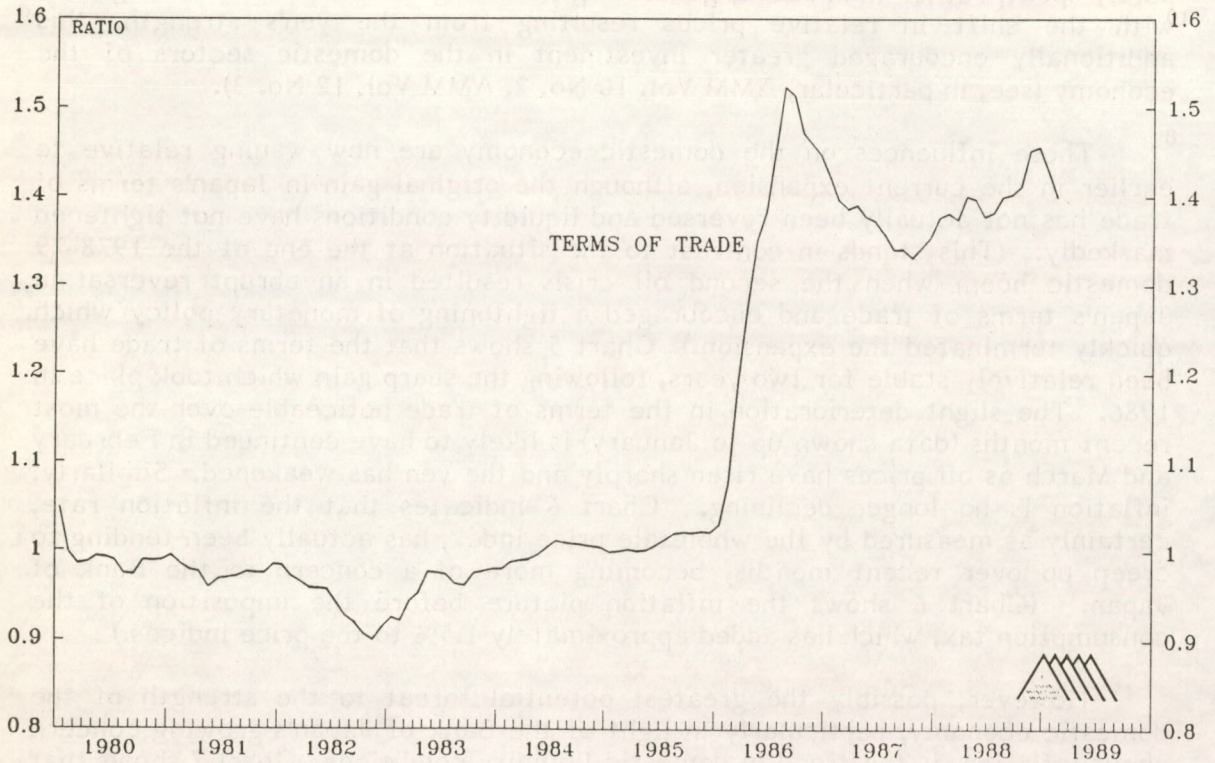
low interest rate environment encouraged the income windfall to be at least partly spent, rather than saved, generating further growth in incomes. Together with the shift in relative prices resulting from the yen's strength, this additionally encouraged greater investment in the domestic sectors of the economy (see, in particular, AMM Vol. 10 No. 2, AMM Vol. 12 No. 3).

These influences on the domestic economy are now waning relative to earlier in the current expansion, although the original gain in Japan's terms of trade has not actually been reversed and liquidity conditions have not tightened markedly. (This stands in contrast to the situation at the end of the 1978-79 domestic boom when the second oil crisis resulted in an abrupt reversal in Japan's terms of trade and encouraged a tightening of monetary policy which quickly terminated the expansion.) Chart 5 shows that the terms of trade have been relatively stable for two years, following the sharp gain which took place in 1986. The slight deterioration in the terms of trade noticeable over the most recent months (data shown up to January) is likely to have continued in February and March as oil prices have risen sharply and the yen has weakened. Similarly, inflation is no longer declining. Chart 6 indicates that the inflation rate, certainly as measured by the wholesale price index, has actually been tending to creep up over recent months, becoming more of a concern to the Bank of Japan. (Chart 6 shows the inflation picture before the imposition of the consumption tax, which has added approximately 1.5% to the price indices.)

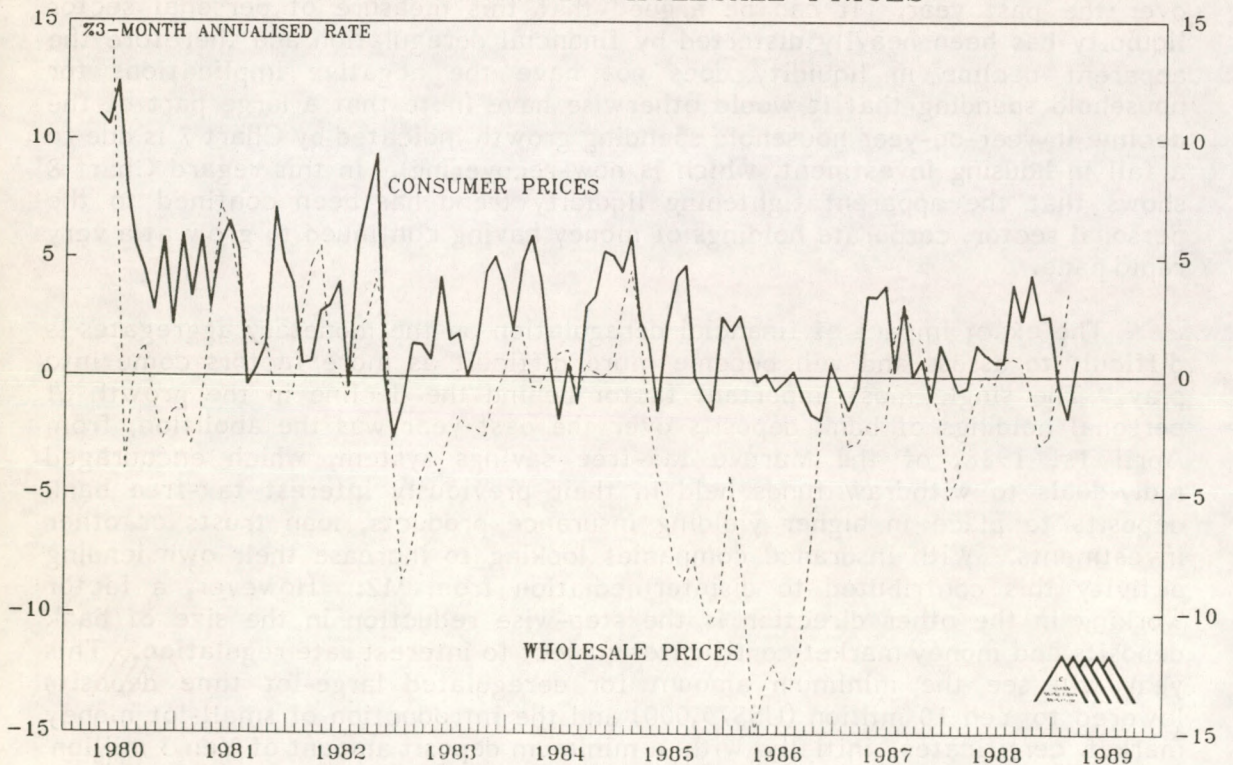
However, possibly the greatest potential threat to the strength of the domestic economy, particularly in light of the Bank of Japan's growing concern about inflation, is the trend in domestic liquidity conditions. Chart 7 shows that by one measure, the growth of money supply held by individuals deflated by the consumer price index, personal sector liquidity has been deteriorating noticeably over the past year. It can be argued that this measure of personal sector liquidity has been heavily distorted by financial deregulation and therefore the apparent decline in liquidity does not have the negative implications for household spending that it would otherwise have (note that a large part of the decline in year-on-year household spending growth indicated by Chart 7 is due to a fall in housing investment, which is now recovering). In this regard Chart 8 shows that the apparent tightening liquidity trend has been confined to the personal sector, corporate holdings of money having continued to grow at a very rapid pace.

The exact impact of financial deregulation on the monetary aggregates is difficult to assess and will become more difficult as more factors come into play. The single most important factor behind the decline in the growth of personal holdings of bank deposits over the past year was the abolition, from April 1st 1988, of the Maruyu tax-free savings system, which encouraged individuals to withdraw funds held in their previously interest tax-free bank deposits to place in higher yielding insurance products, loan trusts or other investments. With insurance companies looking to increase their own lending activity this contributed to disintermediation from M2. However, a factor working in the other direction is the step-wise reduction in the size of bank deposits and money market certificates subject to interest rate regulation. This year will see the minimum amount for deregulated large-lot time deposits lowered to Yen 10 million (US\$75,000) and the introduction of small-lot money market certificates, initially with a minimum deposit amount of Yen 3 million

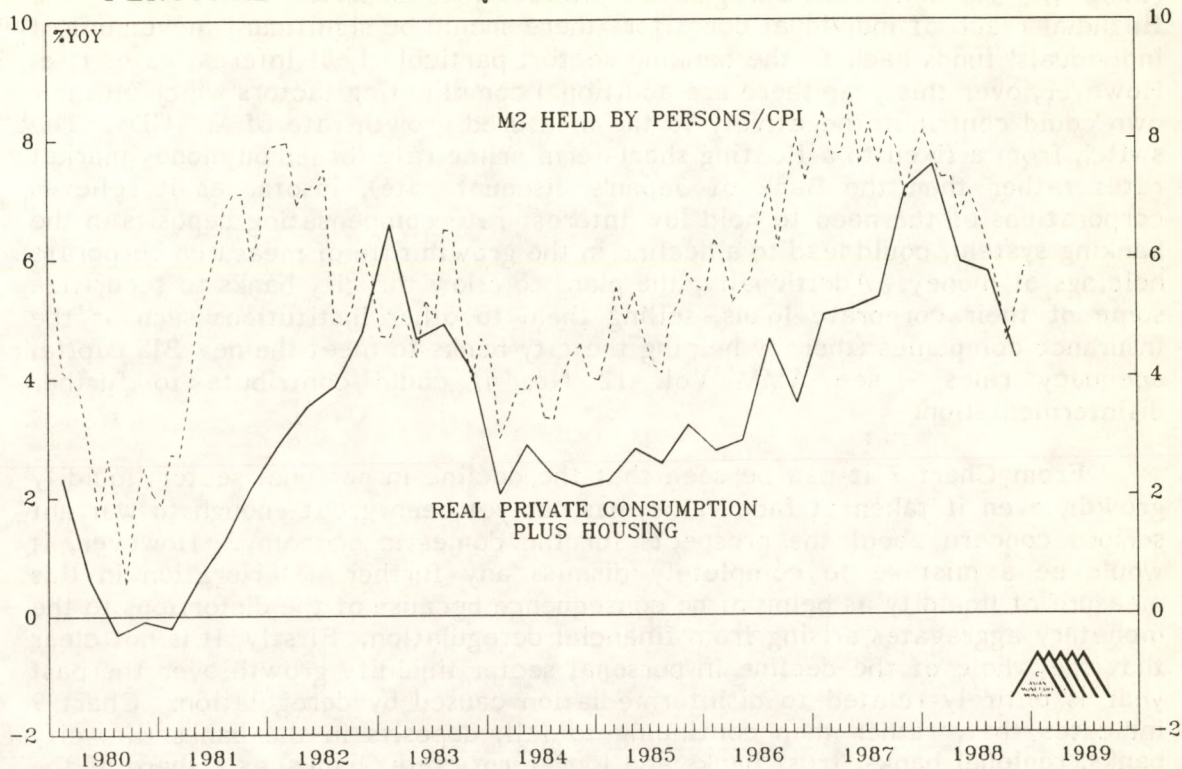
JAPAN: CHART 5
TERMS OF TRADE



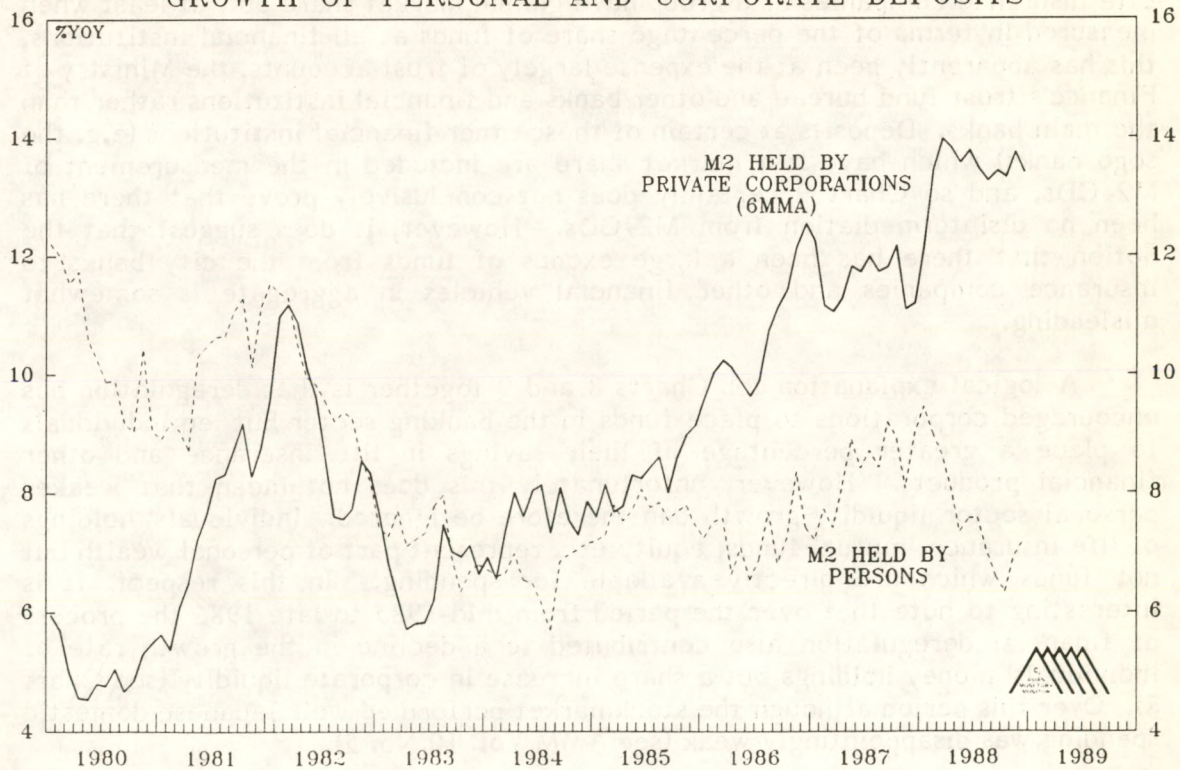
JAPAN: CHART 6
CONSUMER AND WHOLESALE PRICES



JAPAN: CHART 7
PERSONAL SECTOR LIQUIDITY AND CONSUMER SPENDING



JAPAN: CHART 8
GROWTH OF PERSONAL AND CORPORATE DEPOSITS

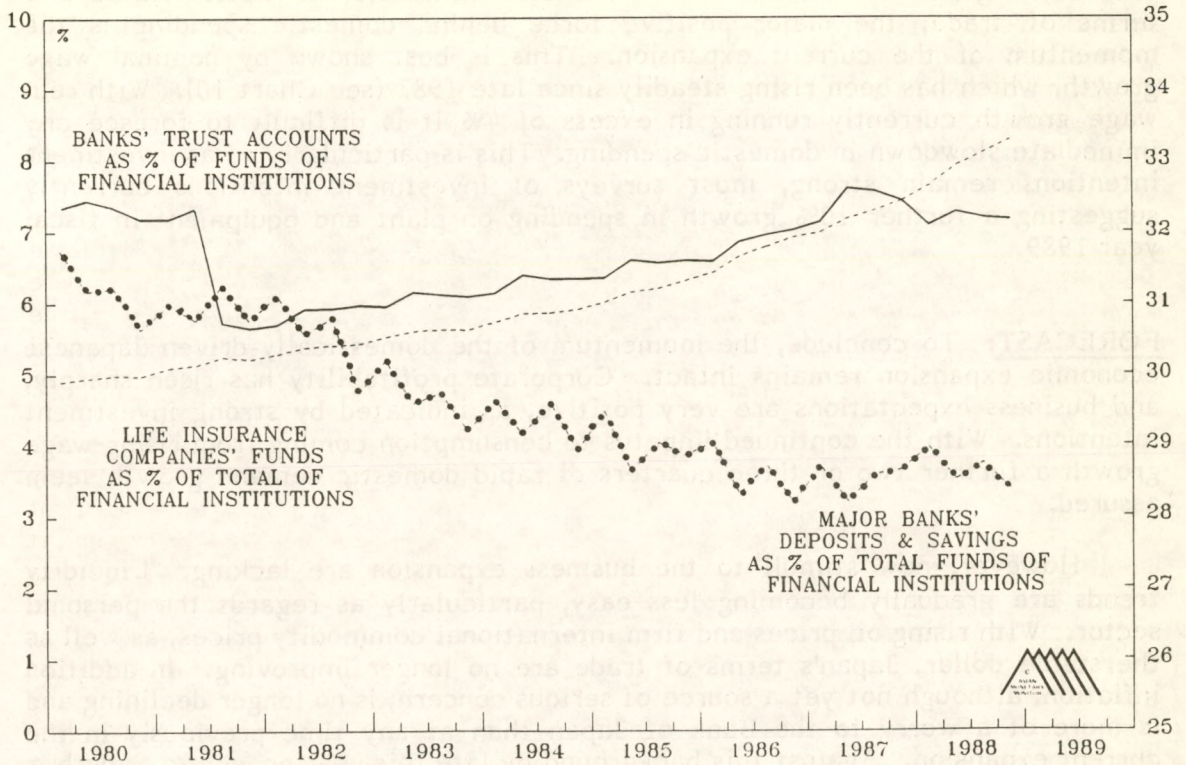


(US\$23,000) but which ultimately could be lowered to only Yen 100,000 (US\$800). As access to unregulated interest rate deposits comes within the financial reach of individual depositors there should be significant movement of individuals' funds back to the banking sector, particularly if interest rates rise. However, over this year there are additional complicating factors which on their own could contribute negatively to the measured growth rate of M2+CDs. The switch from a fixed to a floating short-term prime rate (based on money market rates rather than the Bank of Japan's discount rate), insofar as it relieves corporations of the need to hold low interest rate compensating deposits in the banking system, could lead to a decline in the growth rate of measured corporate holdings of money. Additionally, the plans to allow the city banks to securitize some of their corporate loans, selling them to other institutions such as the insurance companies (thereby helping the city banks to meet the new BIS capital adequacy rules - see AMM Vol. 12 No. 4) could contribute to further disintermediation.

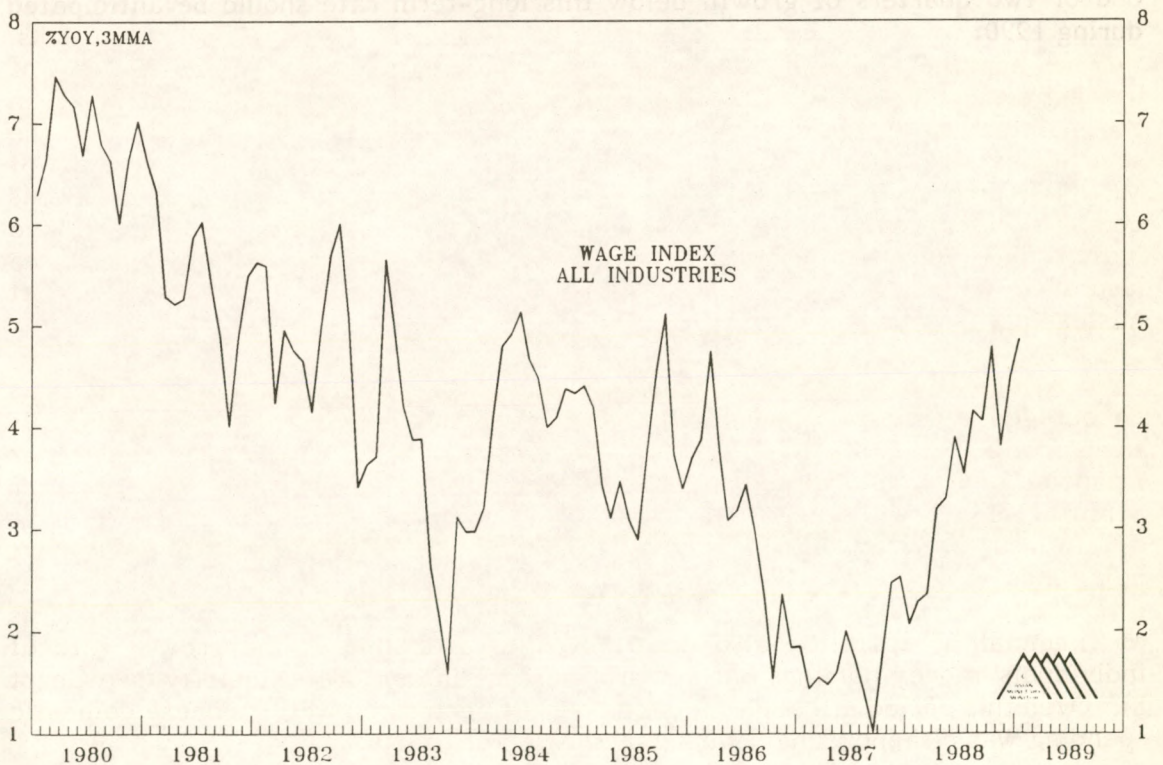
From Chart 7 it can be seen that the decline in personal sector liquidity growth, even if taken at face value, has not yet been great enough to warrant serious concern about the prospects for the domestic economy. However, it would be a mistake to completely dismiss any further deterioration in this measure of liquidity as being of no consequence because of the distortions to the monetary aggregates arising from financial deregulation. Firstly, it is not clear that the whole of the decline in personal sector liquidity growth over the past year is entirely related to disintermediation caused by deregulation. Chart 9 indicates that, rather than continuing to fall, deposits in the banks (i.e. city banks, regional banks, trust banks and long-term credit banks) as a share of the total deposits, certificates of deposit, bank debentures and other funds at all financial institutions, has stabilised, actually rising slightly over the past year. Life insurance companies as a group have gained market share but, at least when measured in terms of the percentage share of funds at all financial institutions, this has apparently been at the expense largely of trust accounts, the Ministry of Finance's trust fund bureau and other banks and financial institutions rather than the main banks. Deposits at certain of these other financial institutions (e.g. the *sogo* banks) which have lost market share are included in the measurement of M2+CDs, and so Chart 9 certainly does not conclusively prove that there has been no disintermediation from M2+CDs. However, it does suggest that the notion that there has been a large exodus of funds from the city banks to insurance companies and other financial vehicles in aggregate is somewhat misleading.

A logical explanation for Charts 8 and 9 together is that deregulation has encouraged corporations to place funds in the banking sector but led individuals to place a greater percentage of their savings in life insurance and other financial products. However, unfortunately this does not mean that weaker personal sector liquidity growth can therefore be ignored. Individuals' holdings of life insurance, mutual funds, equity etc. represent part of personal wealth but not funds which are directly available for spending. In this respect, it is interesting to note that over the period from mid-1985 to late 1986 the process of financial deregulation also contributed to a decline in the growth rate of individuals' money holdings but a sharp increase in corporate liquidity (see Chart 8). Over this period although the stockmarket performed well Japanese domestic spending was disappointingly weak (see AMM Vol. 10 No. 5).

JAPAN: CHART 9
MAJOR INSTITUTIONS' SHARE OF TOTAL FINANCIAL FUNDS



JAPAN: CHART 10
NOMINAL WAGES



Against a background of a somewhat less favourable domestic liquidity environment, and the absence of new stimulus from external factors via Japan's terms of trade, the major positive force behind domestic spending is the momentum of the current expansion. This is best shown by nominal wage growth, which has been rising steadily since late 1987 (see Chart 10). With real wage growth currently running in excess of 4% it is difficult to foresee any immediate slowdown in domestic spending. This is particularly so as investment intentions remain strong, most surveys of investment intentions currently suggesting a further 10% growth in spending on plant and equipment in fiscal year 1989.

FORECAST: To conclude, the momentum of the domestically-driven Japanese economic expansion remains intact. Corporate profitability has risen sharply, and business expectations are very positive, as indicated by strong investment intentions. With the continued impetus to consumption coming from rising wage growth a further two or three quarters of rapid domestic demand growth seem assured.

However, new stimuli to the business expansion are lacking. Liquidity trends are gradually becoming less easy, particularly as regards the personal sector. With rising oil prices and firm international commodity prices, as well as the stable dollar, Japan's terms of trade are no longer improving. In addition inflation, although not yet a source of serious concern, is no longer declining and is more of a worry to the Bank of Japan than at any time previously in the current expansion. Against this background by late this year economic growth is likely to cool towards the long-term sustainable rate of about 4.5%. If exports weaken, as seems probable given the likelihood of a weaker US economy, then one or two quarters of growth below this long-term rate should be anticipated during 1990.

NEW ZEALAND: TIGHT MONEY WILL CONTINUE TO RESTRAIN ECONOMIC RECOVERY

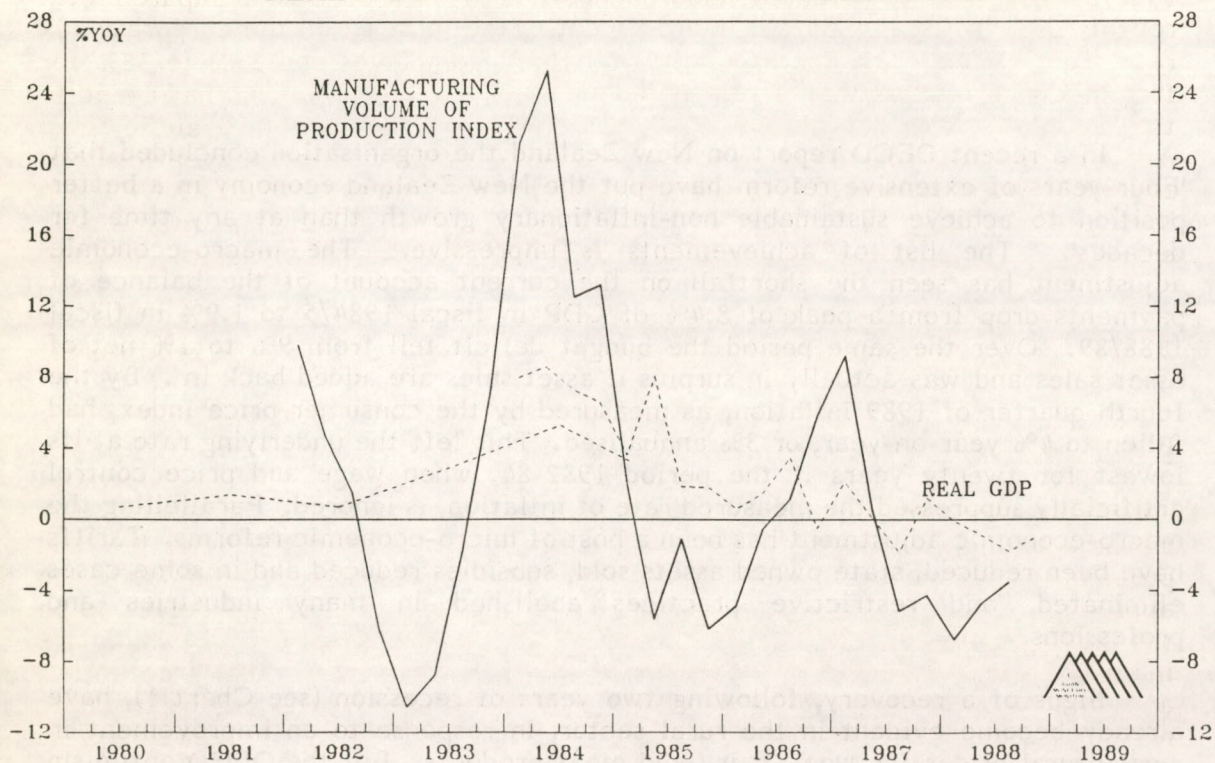
In a recent OECD report on New Zealand the organisation concluded that 'Four years of extensive reform have put the New Zealand economy in a better position to achieve sustainable non-inflationary growth than at any time for decades'. The list of achievements is impressive. The macro-economic adjustment has seen the shortfall on the current account of the balance of payments drop from a peak of 8.4% of GDP in fiscal 1984/5 to 1.9% in fiscal 1988/89. Over the same period the budget deficit fell from 9% to 1% net of asset sales and was actually in surplus if asset sales are added back in. By the fourth quarter of 1989 inflation, as measured by the consumer price index, had fallen to 4% year-on-year, or 3% annualised. This left the underlying rate at its lowest for twenty years if the period 1982-84, when wage and price control artificially suppressed the measured rate of inflation, is ignored. Paralleling the macro-economic adjustment has been a host of micro-economic reforms. Tariffs have been reduced, state owned assets sold, subsidies reduced and in some cases eliminated, and restrictive practices abolished in many industries and professions.

Signs of a recovery, following two years of recession (see Chart 1), have already become evident in the rural sector, in response to an improvement in agricultural prices for wool, dairy and meat products. But the OECD optimism has yet to be reflected in financial asset prices, or in an economic recovery in the urban areas. Real yields on bonds remain at over 10%, more than double the rate prevailing in the major financial centres, while the equity market, traditionally a lead indicator of economic activity, has been one of the worst performing in the world since the crash (Charts 2 and 3). Three factors have continued to overhang prospects for the New Zealand economy: the uncertainties in the property market; the inconsistency in the application of fiscal policy; and a very tight monetary stance.

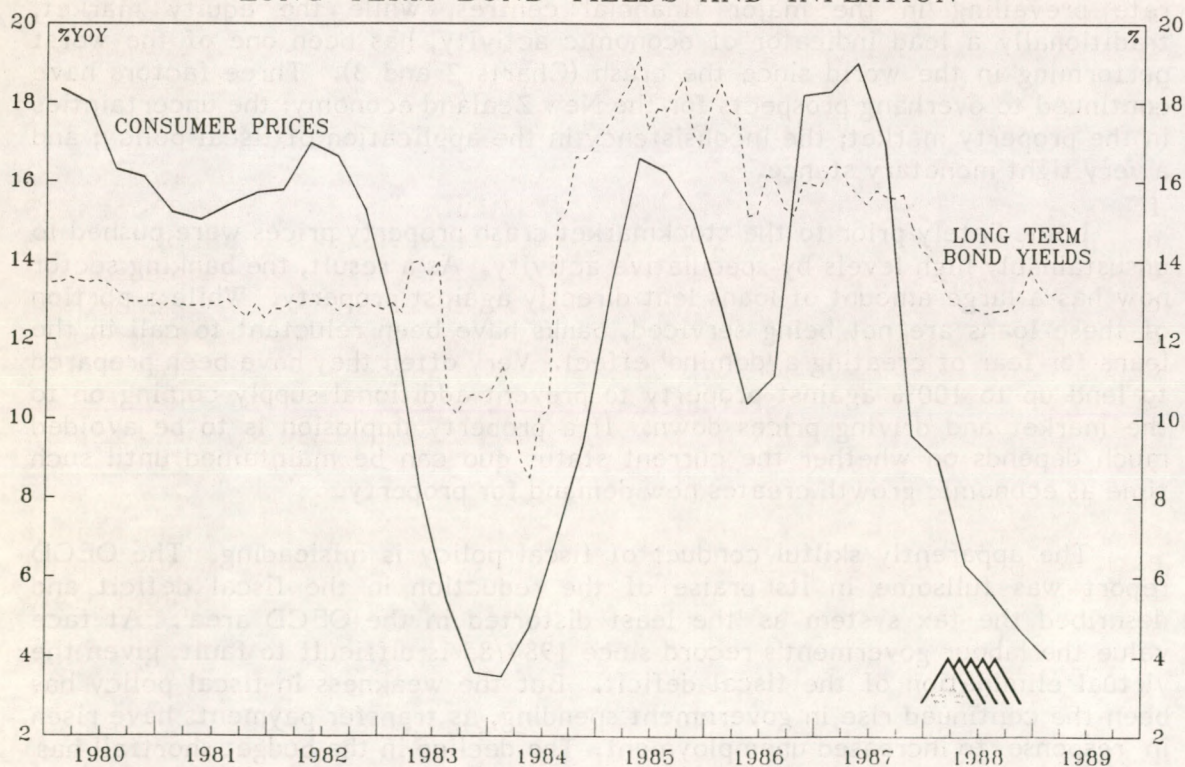
Immediately prior to the stockmarket crash property prices were pushed to unsustainably high levels by speculative activity. As a result, the banking sector now has a large amount of loans lent directly against property. While a portion of these loans are not being serviced, banks have been reluctant to call in the loans for fear of creating a 'domino' effect. Very often they have been prepared to lend up to 100% against property to prevent additional supply coming on to the market and driving prices down. If a property implosion is to be avoided much depends on whether the current status quo can be maintained until such time as economic growth creates new demand for property.

The apparently skilful conduct of fiscal policy is misleading. The OECD report was fullsome in its praise of the reduction in the fiscal deficit and described the tax system as 'the least distorted in the OECD area'. At face value the labour government's record since 1984/85 is difficult to fault, given the virtual elimination of the fiscal deficit. But the weakness in fiscal policy has been the continued rise in government spending, as transfer payments have risen in response to increased unemployment. The decline in the budget shortfall has

NEW ZEALAND: CHART 1
REAL GDP AND INDUSTRIAL PRODUCTION



NEW ZEALAND: CHART 2
LONG TERM BOND YIELDS AND INFLATION



therefore largely been achieved by increased revenue (see Chart 4). By fiscal 1988/89 government revenues had reached nearly 44% of GDP compared with roughly 34% in fiscal 1984/85. More recently, the increase in the corporate tax rate from 28% to 33% for domestic registered companies and 33% to 38% for foreign concerns, less than a year after the rates had been reduced, has added to the concern. This has placed additional burden on the monetary authorities. Against the backdrop of an uncertain fiscal policy and a general scepticism of the authorities' long-term commitment to maintain the progress they have made in reducing inflation, this has necessitated the Reserve Bank maintaining an extremely tight policy.

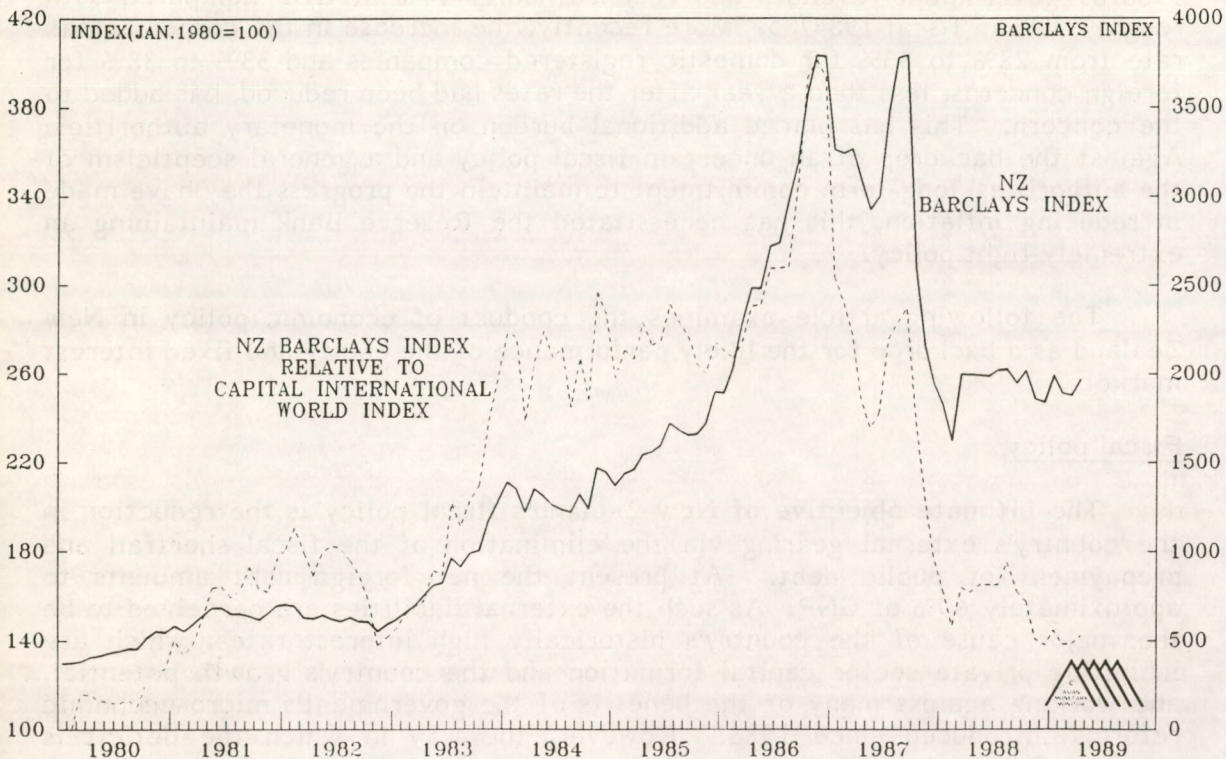
The following article examines the conduct of economic policy in New Zealand as a backdrop for the likely performance of the equity and fixed interest markets.

Fiscal policy

The ultimate objective of New Zealand's fiscal policy is the reduction in the country's external gearing via the elimination of the fiscal shortfall and prepayment of public debt. At present the net foreign debt amounts to approximately 60% of GNP. As such the external liabilities are perceived to be the major cause of the country's historically high interest rates, which are inhibiting private sector capital formation and the country's growth potential, and working against many of the benefits of the government's micro-economic reforms introduced since 1988. However, the way in which the deficit is eliminated is as important as the reduction itself. In New Zealand too much emphasis has been placed on reducing the actual budget shortfall and not enough in reversing the steady rise in government expenditure. The 1989/90 budget arithmetic illustrates this point, highlighting that it is difficult to escape the conclusion that the authorities have become overly concerned with the mechanics of debt reduction without focusing on the economic impact of their actions.

Prior to the measures announced in the March budget the estimated deficit for the fiscal 1989/90 year was a budget shortfall of NZ\$2,850 m or 3% of GDP net of asset sales, compared with an estimated outturn of NZ\$1.0 billion, or 1.2% of GDP, in fiscal 1988/89 (Table 1). The authorities felt that this increase in the deficit would result in rising interest rates and further dampen business and consumer confidence. Consequently, following tax increases and expenditure cuts the shortfall was reduced to NZ\$900 m, or 1% of GDP, with the greater part of the reduction accounted for by tax increases, of which just one third, or NZ\$300 m, is to be garnered via an increased corporate tax rate (see Table 1). The additional revenue gained by raising the corporate tax rate - which amounts to just 0.3% of GDP - is totally disproportionate to the adverse economic consequences. In economic terms two aspects of the budget are working against each other. The budget shortfall is reduced to lower interest rates and capital formation. But at the same time corporate taxes are raised, inhibiting private sector capital formation.

NEW ZEALAND: CHART 3 BARCLAYS STOCK INDEX AND PERFORMANCE RELATIVE TO THE WORLD



NEW ZEALAND: CHART 4 GOVERNMENT EXPENDITURE AND REVENUE AS % OF GDP

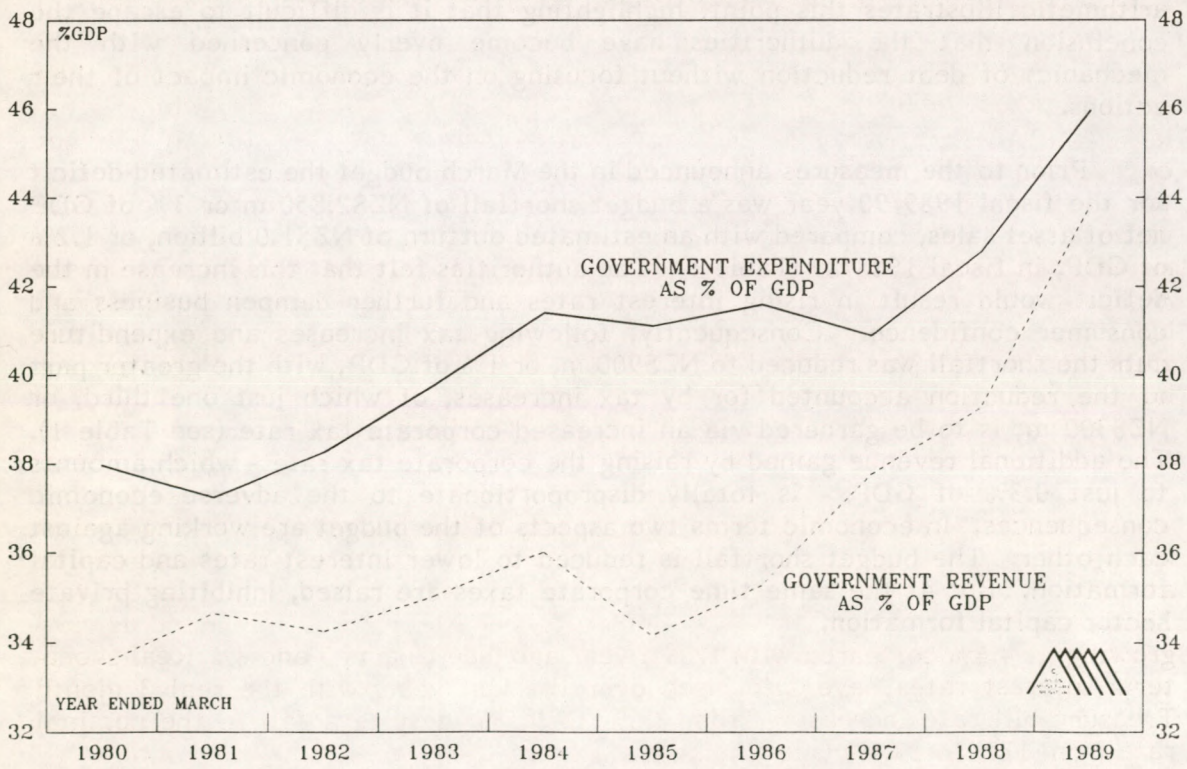


TABLE 1

Tax and expenditure changes for fiscal 1989/90

	NZ\$m
Estimated deficit prior to budget measures	-2850
Expenditure cuts	657
Net Revenue increase (including)	993
Company tax increase	300
GST	973
Financial Deficit	-900

A recent publication, 'Economic Forecasts', of the Reserve Bank of New Zealand noted that at least in the short-term the impact of higher corporate taxes would be that 'lower after-tax company profits are initially expected to more than negate any positive stimulus from lower interest rate levels'. But it then went on to add 'However, beyond the first year, an anticipated decline in interest rates - facilitated by the containment of the fiscal deficit - should serve to encourage consumption and investment, giving a higher growth profile than would otherwise have eventuated'. Although this observation would essentially need to be subjected to econometric verification it must be considered as extremely unlikely, without a major contribution from monetary policy.

The experiences of the UK and Australia, both of which have eliminated budget deficits and begun a programme of debt repayment but have nevertheless experienced rising real interest rates and deteriorating external balances, indicates that inflationary expectations and the savings rate of the private sector are equally important determinants of real interest rates.

In New Zealand other forces, including the inconsistencies in the application of fiscal policy highlighted previously (another aspect of which is the large borrowing requirement of the state owned enterprises which are not counted in the government's figures for the fiscal deficit), are also contributing to maintaining high real rates. Other probable causes include: political uncertainties, with the opinion polls showing the government's popularity rating running at about half the level of the opposition; the high and rising yields on Australian bonds, which tend to be regarded as close substitutes for New Zealand bonds in foreign investors' portfolios; and the uncertainty regarding the tax treatment of pension funds, which has resulted in a reduction in demand for bonds from this source.

Monetary policy

The implication is that more of the burden of adjustment will be placed on monetary policy which at present remains very tight. By March M3 was growing at 2.2% year-on-year, representing a 2% decline in real terms, compared with 13.3% at the beginning of 1988, while private sector credit demand is now growing at 4.4% compared with 17% a year ago (see Charts 5 and 6). Real short-term interest rates have also risen over the last year, with the real 3 month Treasury bill rate increasing from 3.6% to 9.5%, despite a fall in the nominal rate from 17% to 13.5% (see Chart 7).

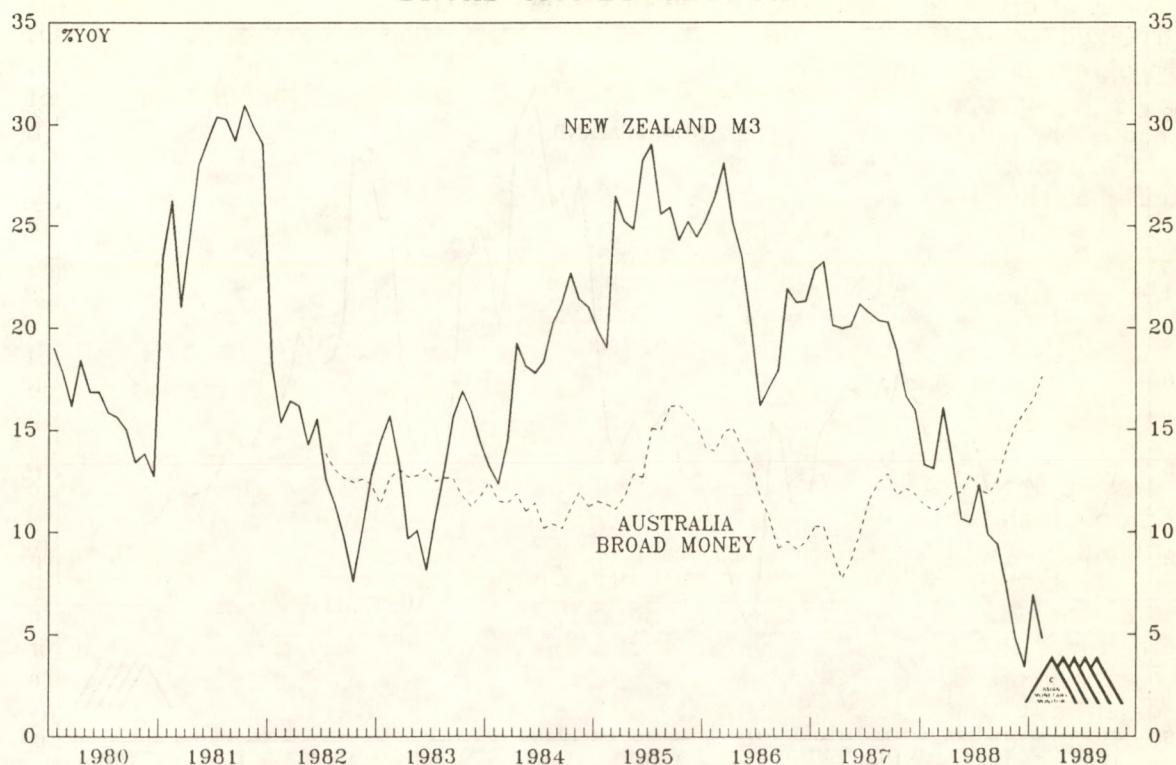
While the conduct of monetary policy has also from time to time been the focus of criticism, particularly between late 1985 and late 1986 when policy was relaxed prematurely in the face of the sharp economic slowdown in 1985, progress in reducing the rate of inflation has been nothing less than impressive. The Reserve Bank has constantly reviewed the efficiency of the conduct of monetary policy and introduced improvements. The most recent example was in July last year when it created the Reserve Bank bill to improve its control over primary liquidity. The Reserve Bank bill constitutes a liability of the central bank and is similar to the Central Bank Certificate of Deposit and the Monetary Stabilisation Bond, the major sterilisation instruments issued in Taiwan and Korea respectively.

The Reserve Bank implements monetary policy through altering the level of primary liquidity. Since last July primary liquidity is defined to include Reserve Bank bills with a maturity of less than 30 days, which the Reserve Bank is willing to discount for cash, as well as cash balances held by the banking system at the Reserve Bank. As both components are the liabilities of the central bank it should therefore be able to exercise close control over primary liquidity. On the assumption that the demand for primary liquidity is reasonably stable because transactions between the banking system must be settled in liabilities of the central bank, the Reserve Bank is therefore able to influence the level of short term interest rates and ultimately the growth in private sector credit demand. The central bank's techniques of monetary control are therefore essentially quantitative, but rely on interest rates to influence the real economy and inflation.

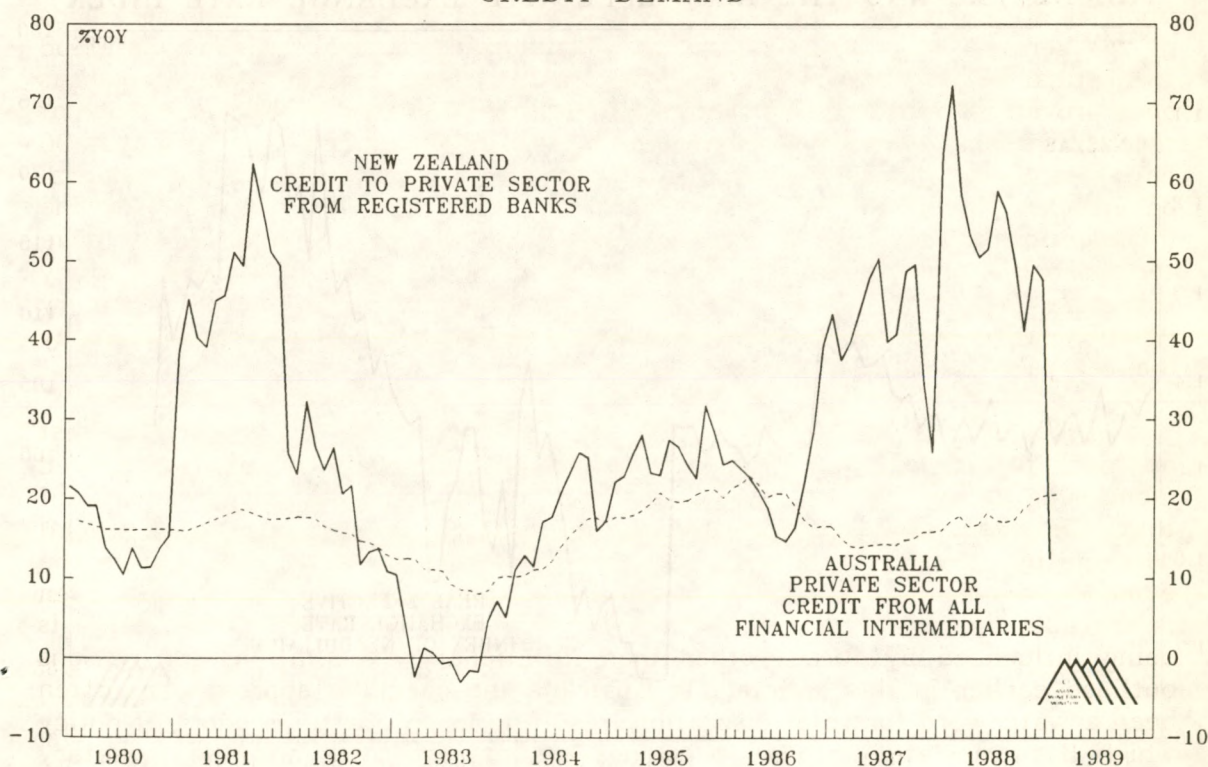
Initially it was thought that there might be a close link between primary liquidity and the monetary aggregates. In fact because the definition of primary liquidity differs from the monetary base in omitting notes and coins in the hands of the general public and in including discountable assets, there was no good theoretical reason to suppose this would be the case, an assumption which has been proven by developments. In its original form primary liquidity consisted of the liabilities of the government (Treasury bills) with a maturity of less than 30 days plus the liabilities of the Reserve Bank to the banking system (operational balances). The weakness of this approach, which has been remedied by the introduction of the Reserve Bank bill, was that the Reserve Bank did not have the monopoly over the issue of Treasury bills. The conduct of monetary policy therefore frequently came into conflict with debt management. Primary liquidity was subject to periodic distortion owing to seasonality in the money market, particularly over tax payment periods.

Like the Australian authorities the Reserve Bank also has a checklist approach to gauging the correct stance of monetary policy, which has involved monitoring a range of real and monetary indicators. This stems from the belief that the monetary aggregates have been distorted by ongoing financial deregulation. Furthermore the yield curve, which is currently flat, despite the evidence of falling real money growth and weak credit demand, has been downgraded as an indicator of monetary conditions, because the bond market is being influenced by forces other than inflationary expectations for reasons outlined earlier in this article. In Australia the checklist approach has often been a watchword for total discretion, resulting in an erratic conduct of policy which has translated into wide swings in interest rates and the monetary

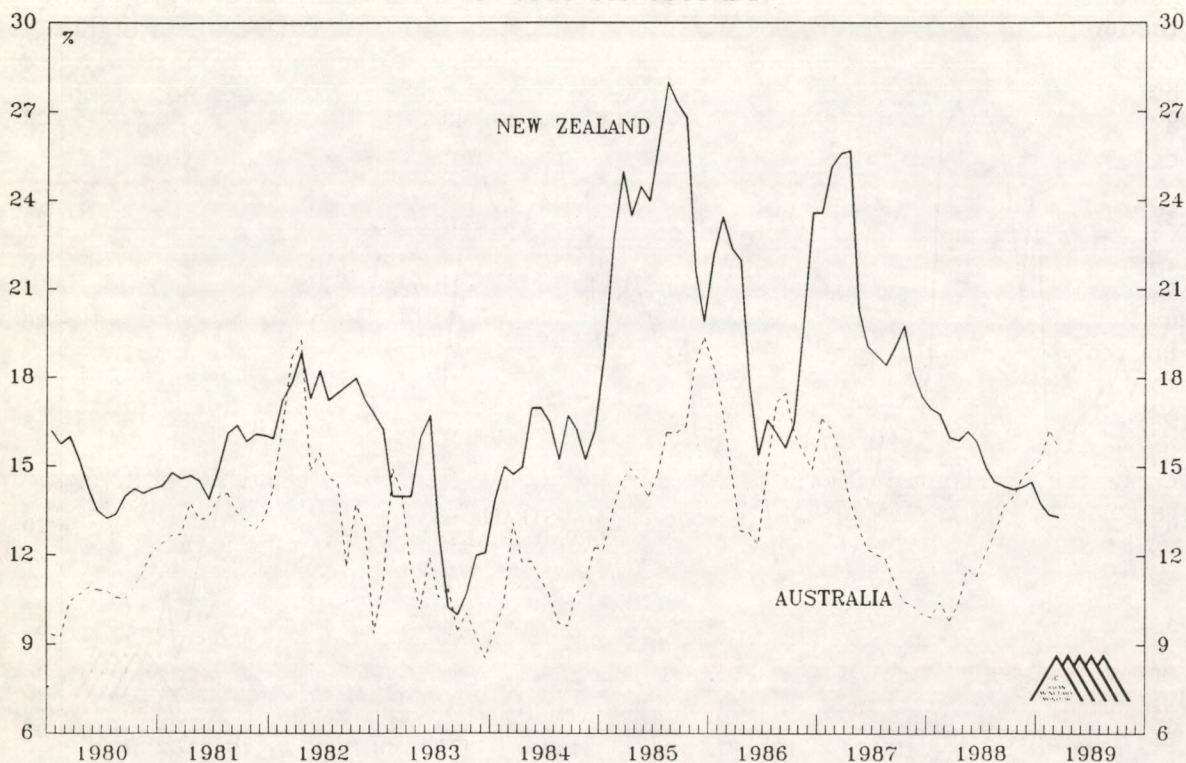
NEW ZEALAND AND AUSTRALIA: CHART 5
BROAD MONEY GROWTH



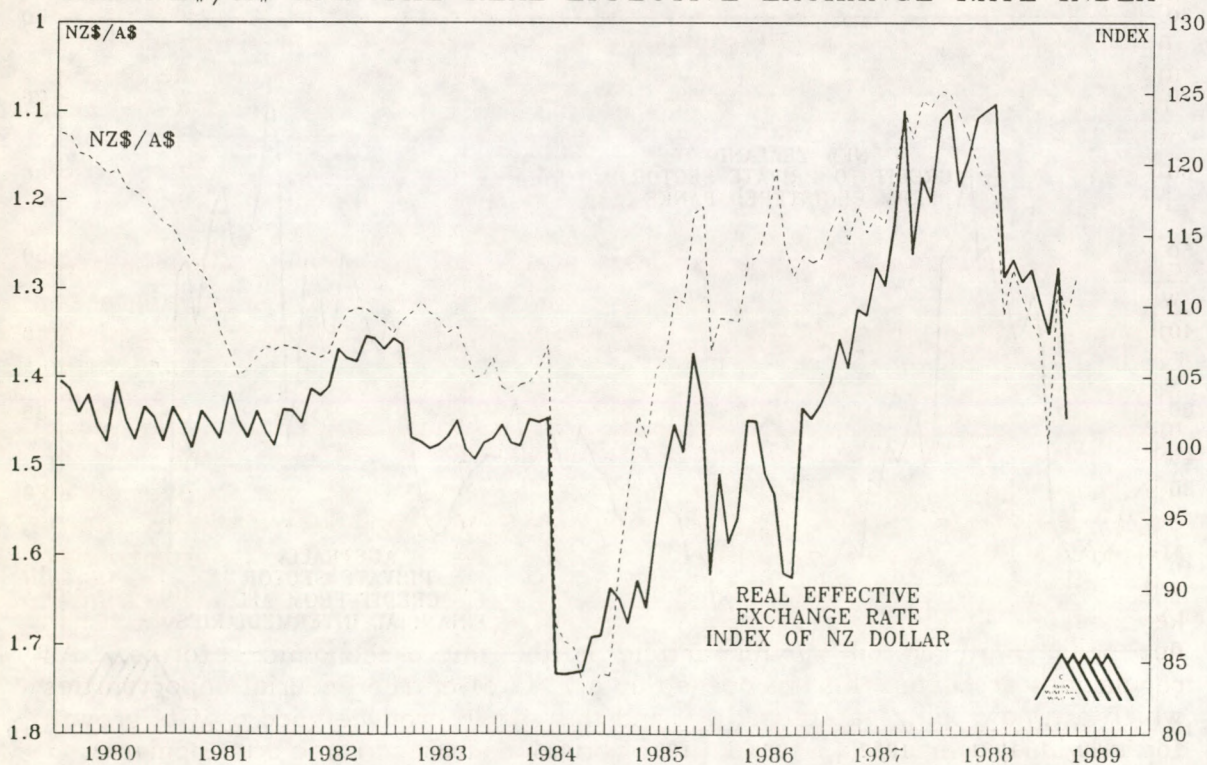
NEW ZEALAND VS AUSTRALIA: CHART 6
CREDIT DEMAND



NEW ZEALAND AND AUSTRALIA: CHART 7 3-MONTH MONEY



NEW ZEALAND: CHART 8 THE NZ\$/A\$ AND THE REAL EFFECTIVE EXCHANGE RATE INDEX



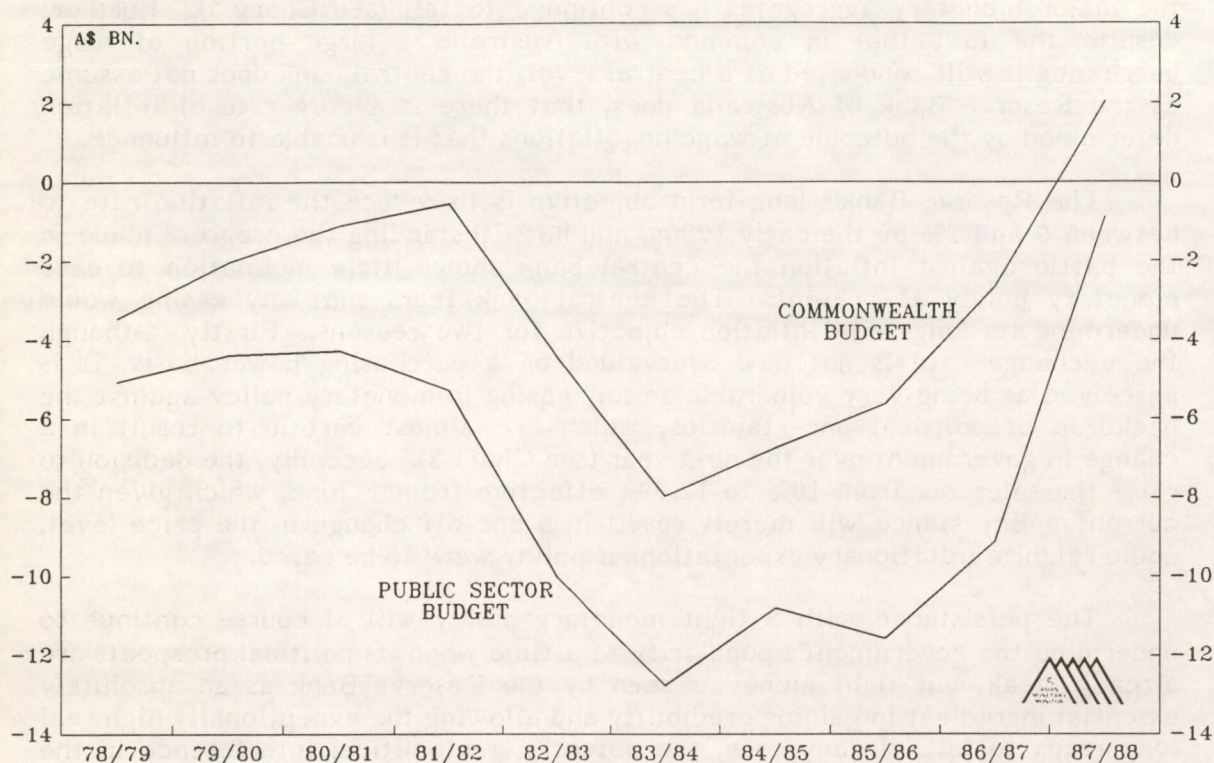
aggregates. But unlike the Australian authorities the New Zealand central bank has ensured that, notwithstanding the difficulties in interpretation, the growth of the major monetary aggregates has continued to fall (see Chart 5). Further, despite the fact that in common with Australia a large portion of wage bargaining is still conducted at a central level, the central bank does not assume as the Reserve Bank of Australia does, that there is a core rate of inflation determined by the outcome of wage negotiations that it is unable to influence.

The Reserve Bank's long-term objective is to reduce the inflation rate to between 0 and 2% by the early 1990s, and notwithstanding the progress made in the battle against inflation the central bank shows little inclination to ease monetary policy at present. The central bank fears that any easing would undermine its long-term inflation objective for two reasons. Firstly, although the exchange rate is not now overvalued on a purchasing power basis, it is perceived as being very vulnerable to any easing in monetary policy against the backdrop of political uncertainties, which are almost certain to result in a change in government over the next year (see Chart 8). Secondly, the decision to raise the sales tax from 10% to 12.5%, effective from 1 June, which given the current policy stance will merely result in a one-off change in the price level, could reignite inflationary expectations if policy were to be eased.

The persistence with a tight monetary policy will of course continue to undermine the government's popularity at a time when its political prospects are already bleak, but tight money is seen by the Reserve Bank as an absolutely essential ingredient in gaining credibility and allowing the exceptionally high real long rates to fall. In any case, the potential for political interference in the setting of monetary policy, which has been a hallmark of Australian policy over the last year and was also a feature of New Zealand policy prior to 1985, is limited by impending legislation. The new Reserve Bank Act due to be introduced later this year will insulate the central bank from political interference, establishing the independence of the central bank along the lines of the Federal Reserve Board of the US. Under the Act the central bank will still be required to issue and publish general objectives such as the desire to reduce inflation to a certain level, but the ability of the government to interfere will be limited to getting an 'order in council' to overturn any objective.

FORECAST: It therefore seems likely that monetary conditions in New Zealand will remain tight until such time as the political uncertainties have evaporated, inconsistencies in the application of fiscal policy have been resolved, and the credibility of the central bank's determination to achieve a permanent reduction in the rate of inflation has been established. For New Zealand's equity and bond markets this means that the under-performance in the indices since the crash will continue for a further 6 months or so. But while the recovery in the markets may have been further delayed it does suggest that, when the recoveries do occur, the moves in the financial markets will be large and extremely rapid. Neither do tight money conditions necessarily mean that while the broad index will find it difficult to make headway, individual stocks will not perform well. A key characteristic of the restructuring of the New Zealand economy which has not been dwelt up on in this article is the micro-economic reforms. As regulations are lifted this has opened up a vista of entrepreneurial opportunities which are now being capitalised on, and this should produce good profits growth for individual companies, irrespective of broad macro-economic developments.

AUSTRALIA: FISCAL POLICY NOT AS TIGHT AS PERCEIVED

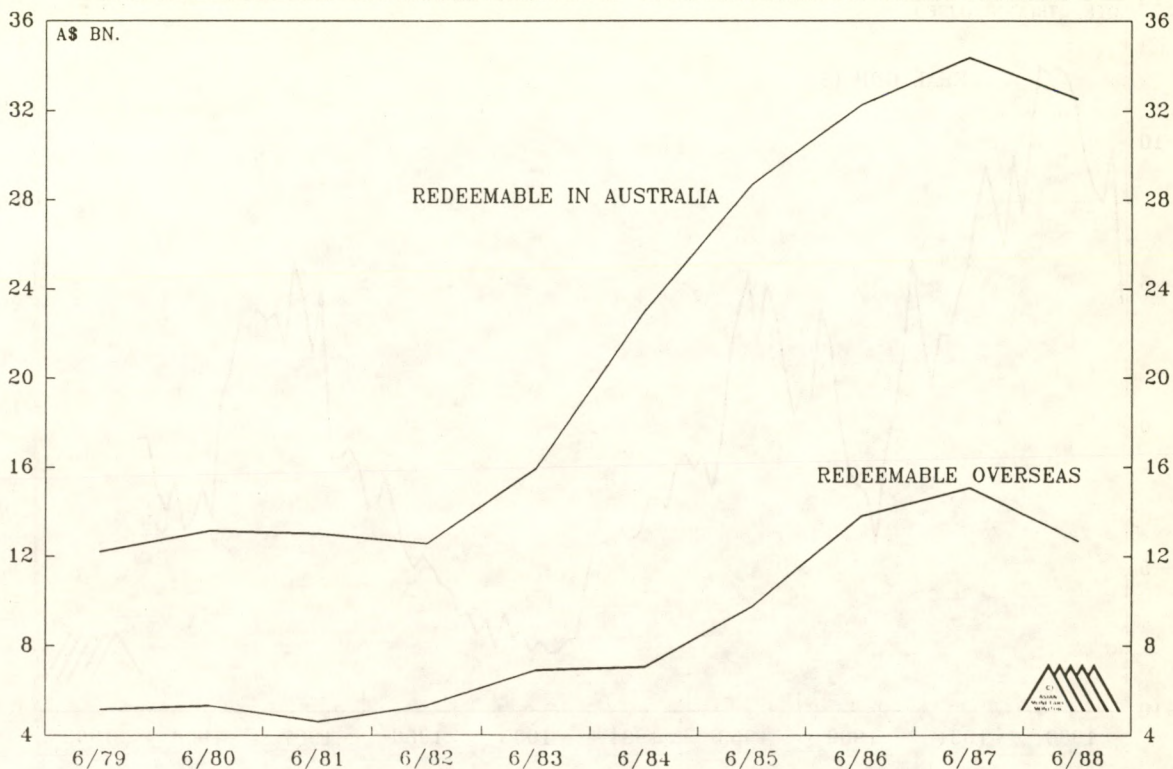


In a recent statement the Australian Treasurer, Paul Keating, described fiscal policy as being 'as tight as a drum'. This followed the announcement of an expected A\$5.5 billion Commonwealth budget surplus for fiscal 1989/90, even after total personal tax concessions of A\$5.5 billion, and following a surplus for 1988/89 which is expected to exceed A\$6 billion. However, apart from the fact that the more broadly defined Public Sector Borrowing Requirement only remains in balance, despite heavy asset sales, owing to a large deficit which is being run by the state governments, several other aspects also suggest that fiscal policy is not as tight as the Treasurer perceives.

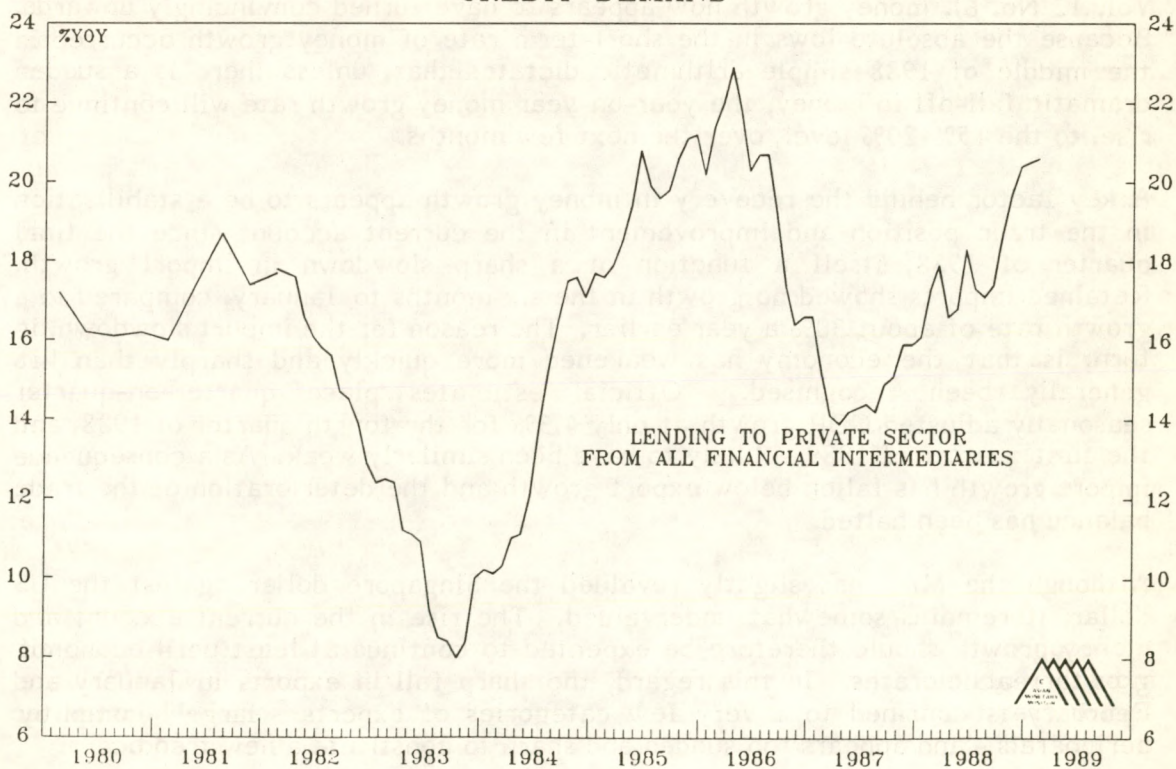
In previous editions of AMM we have pointed out that the Reserve Bank of Australia stands ready to provide the banking system with all the liquidity it requires, though at rates of its own choosing. The tax concessions announced could therefore result in a higher rate of money growth. Further, the retirement of outstanding Commonwealth debt, which constitutes a future tax claim on the private sector, could also have an expansionary impact via increasing the permanent income of the private sector. The expected future disposable income stream is revised upwards.

At best the current stance of fiscal policy is neutral, which partly explains why the economy has taken so long to slow in response to the steady tightening of monetary policy. The key to when the economy eventually slows is when private sector credit demand eventually ebbs. With personal incomes being boosted by the tax reductions effective from July, this may still take some time to occur.

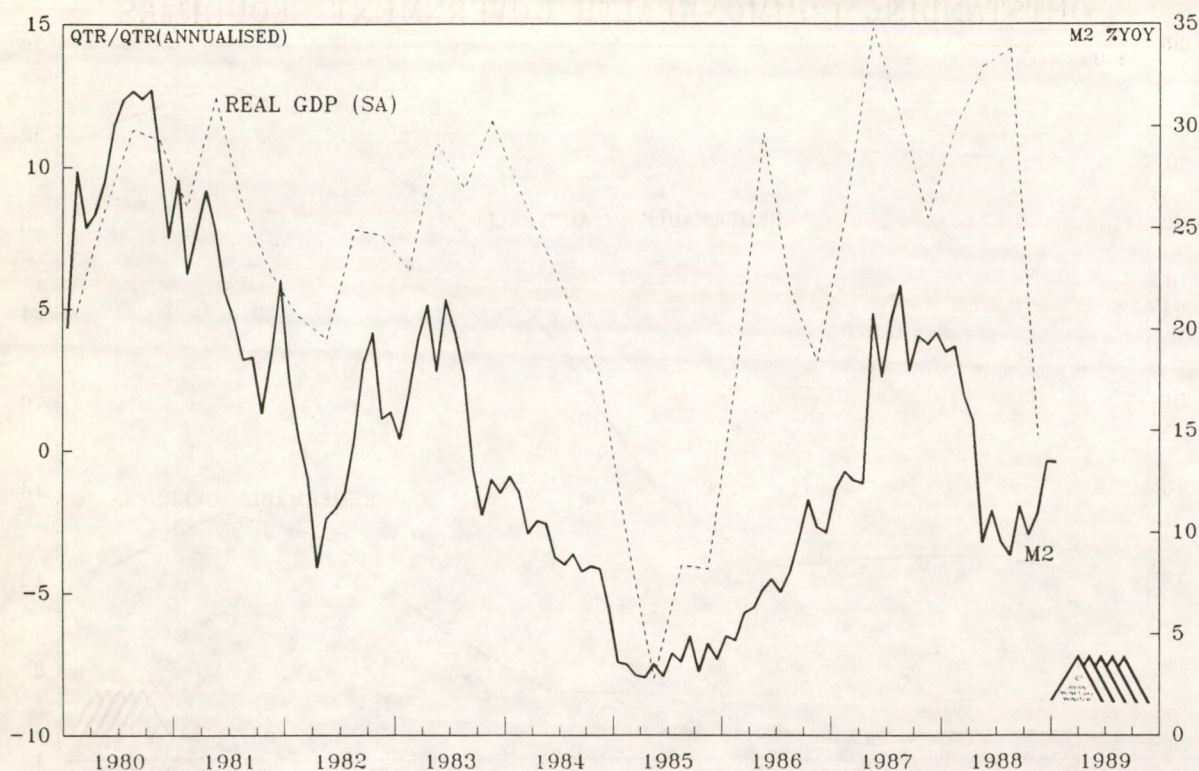
AUSTRALIA OUTSTANDING COMMONWEALTH GOVERNMENT SECURITIES



AUSTRALIA CREDIT DEMAND



SINGAPORE: MONEY GROWTH RISES AS THE ECONOMY SLOWS

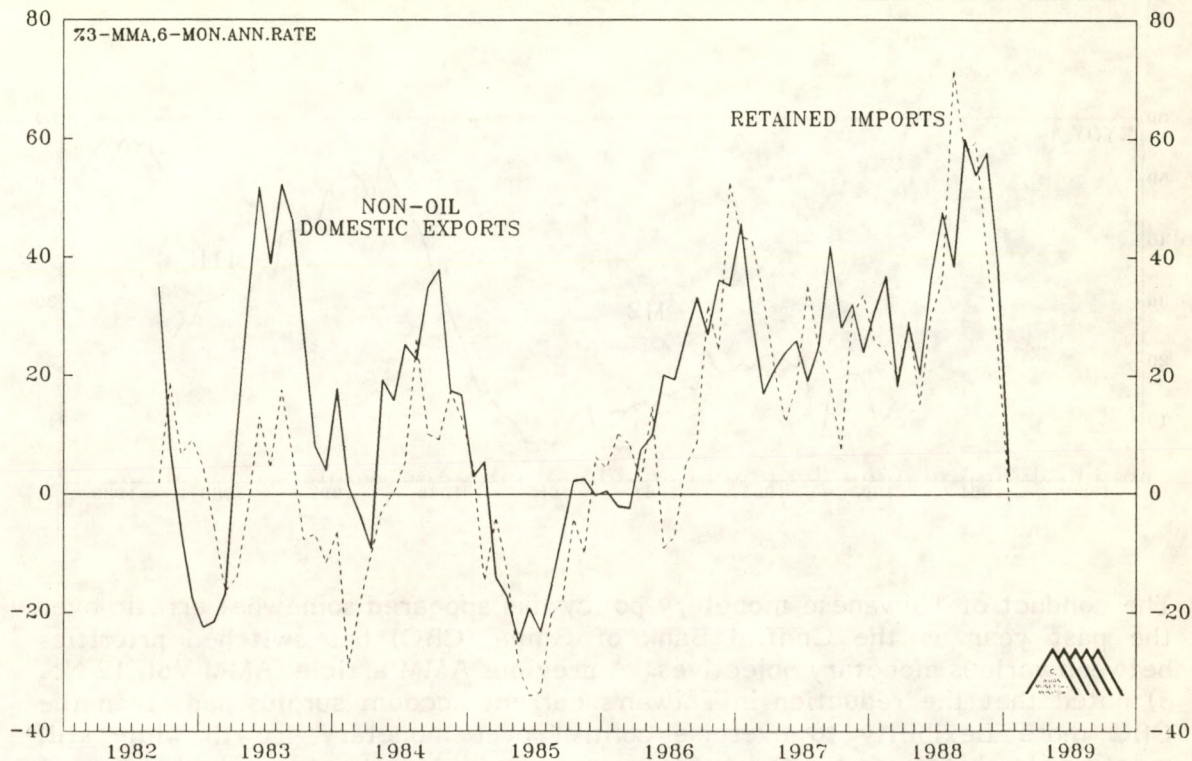


Following the sharp decline in money growth which resulted from the Monetary Authority of Singapore's (MAS) tightening of monetary policy in 1988 (see AMM Vol. 12 No. 6), money growth now appears to have turned convincingly upwards. Because the absolute lows in the short-term rate of money growth occurred in the middle of 1988 simple arithmetic dictates that, unless there is a sudden dramatic fall-off in money, the year-on-year money growth rate will continue to rise, to the 15%-20% level, over the next few months.

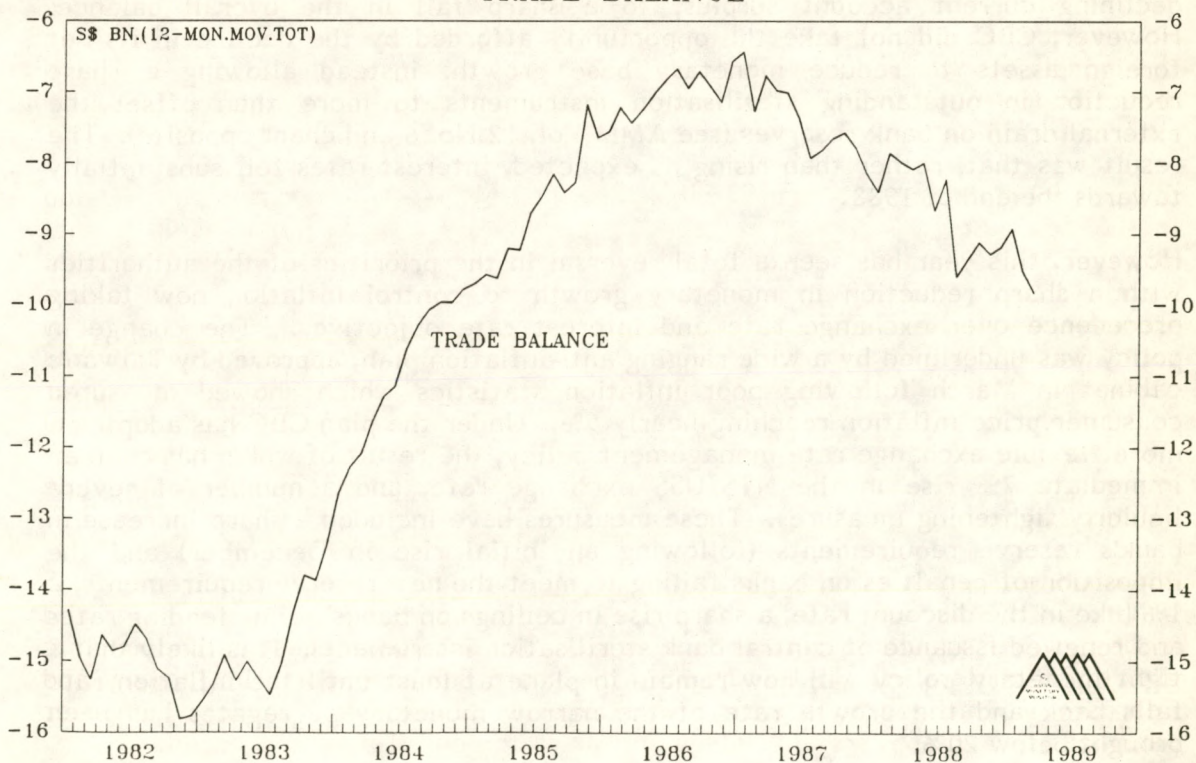
A key factor behind the recovery in money growth appears to be a stabilisation in the trade position and improvement in the current account since the final quarter of 1988, itself a function of a sharp slowdown in import growth. Retained imports showed no growth in the six months to January, compared to a growth rate of about 30% a year earlier. The reason for the import slowdown, in turn, is that the economy has weakened more quickly and sharply than has generally been recognised. Official estimates place quarter-on-quarter seasonally adjusted GDP growth at only 4.3% for the fourth quarter of 1988, and the first quarter of 1989 is likely to have been similarly weak. As a consequence import growth has fallen below export growth and the deterioration of the trade balance has been halted.

Although the MAS has slightly revalued the Singapore dollar against the US dollar, it remains somewhat undervalued. The rise in the current account and money growth should therefore be expected to continue at least until economic growth reaccelerates. In this regard, the sharp fall in exports in January and February is confined to a very few categories of exports - largely computer peripherals - and appears too sudden and sharp to constitute a new trend.

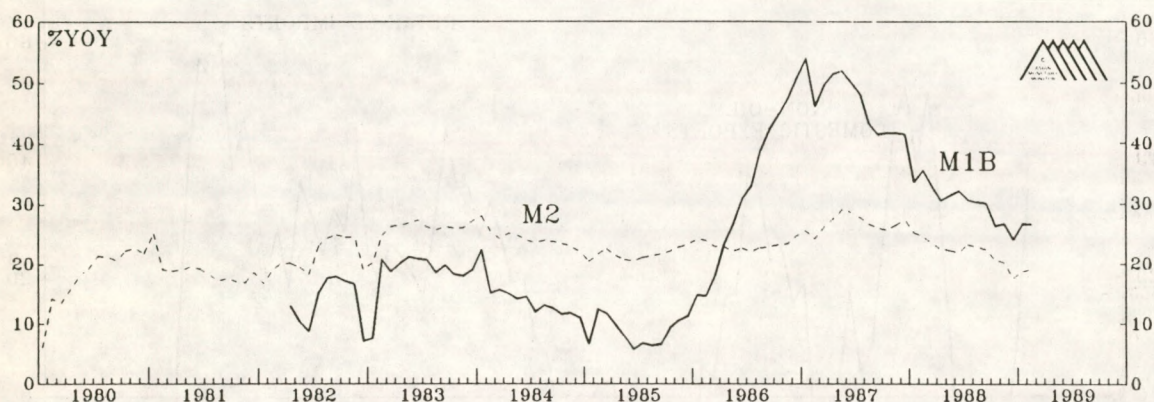
SINGAPORE NON-OIL DOMESTIC EXPORTS AND RETAINED IMPORTS



SINGAPORE TRADE BALANCE



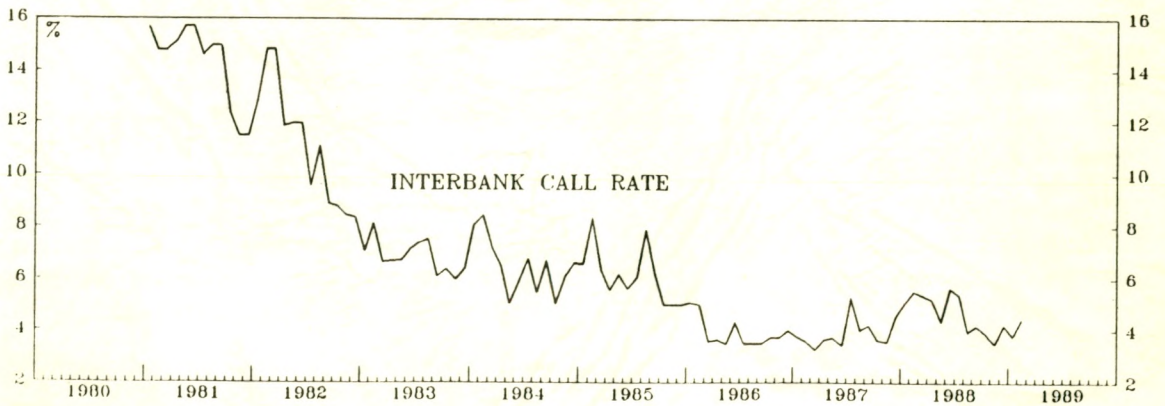
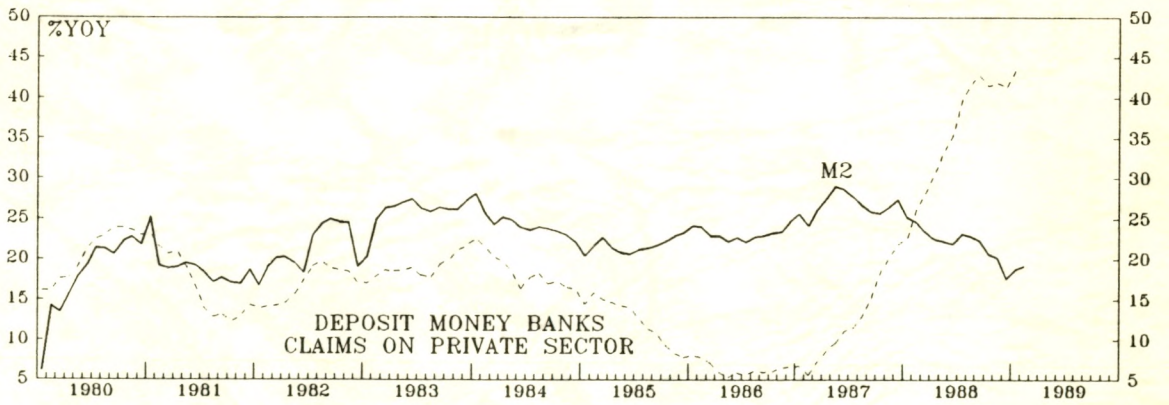
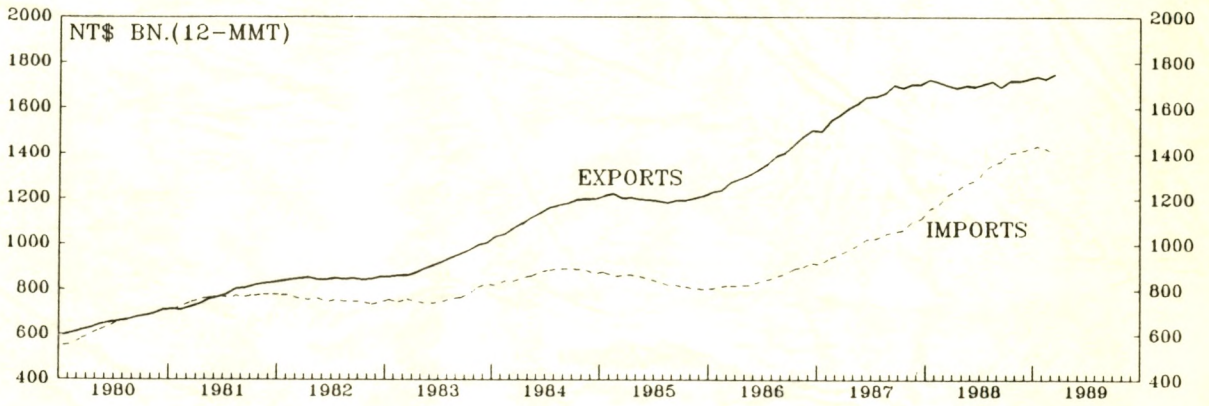
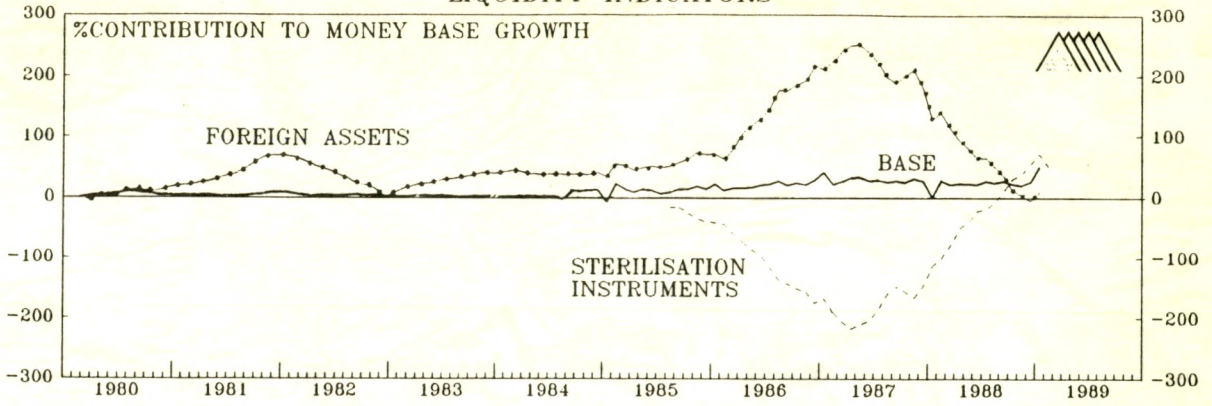
TAIWAN: CONTROLLING INFLATION NOW THE CENTRAL BANK'S OVERRIDING PRIORITY



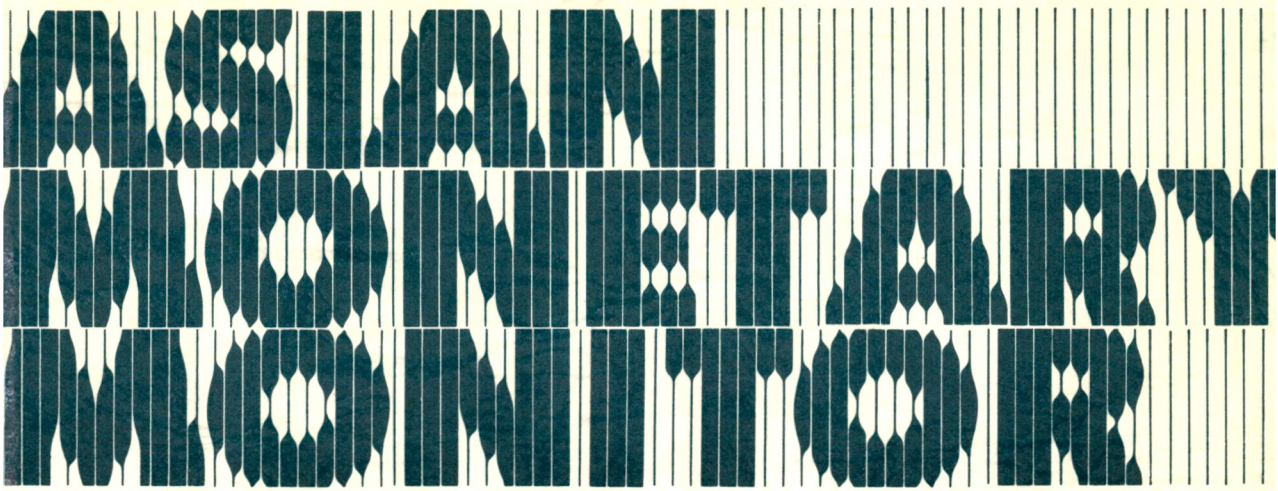
The conduct of Taiwanese monetary policy has appeared somewhat erratic over the past year as the Central Bank of China (CBC) has switched priorities between various monetary objectives. A previous AMM article (AMM Vol. 12 No. 3) noted that the reduction in Taiwan's current account surplus had given the CBC more flexibility to exercise control over monetary growth while still meeting its objectives for the exchange rate and interest rates. The balance of payments surplus was virtually eliminated during 1988 as overseas direct and portfolio investment and short-term capital outflows contributed, along with the declining current account surplus, to a sharp fall in the overall balance. However, CBC did not take the opportunity afforded by the decline in its net foreign assets to reduce monetary base growth, instead allowing a sharp reduction in outstanding sterilisation instruments to more than offset the external drain on bank reserves (see AMM Vol. 12 No. 6 and chart opposite). The result was that, rather than rising as expected, interest rates fell substantially towards the end of 1988.

However, this year has seen a total reversal in the priorities of the authorities with a sharp reduction in monetary growth to control inflation now taking precedence over exchange rate and interest rate objectives. The change in policy was underlined by a wide ranging anti-inflation plan, approved by Taiwan's cabinet in March following poor inflation statistics which showed measured consumer price inflation reaching nearly 5%. Under the plan CBC has adopted a more flexible exchange rate management policy, the result of which has been an immediate 7% rise in the NT\$/US\$ exchange rate, and a number of severe liquidity tightening measures. These measures have included a sharp increase in bank's reserve requirements (following an initial rise in December) and the imposition of penalties on banks failing to meet the new reserve requirements, a 1% hike in the discount rate, a sharp rise in ceilings on banks' prime lending rates and renewed issuance of central bank sterilisation instruments. It is likely that a tight monetary policy will now remain in place at least until the inflation rate falls back and the growth rate of the narrow monetary aggregates has been brought below 20%.

TAIWAN LIQUIDITY INDICATORS





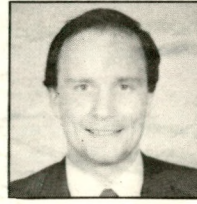


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John G. Greenwood
Publisher
Group Economist
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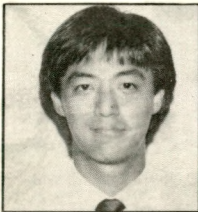
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REGIONAL SURVEY: INTRA-REGIONAL TRADE AND INVESTMENT IN EAST ASIA

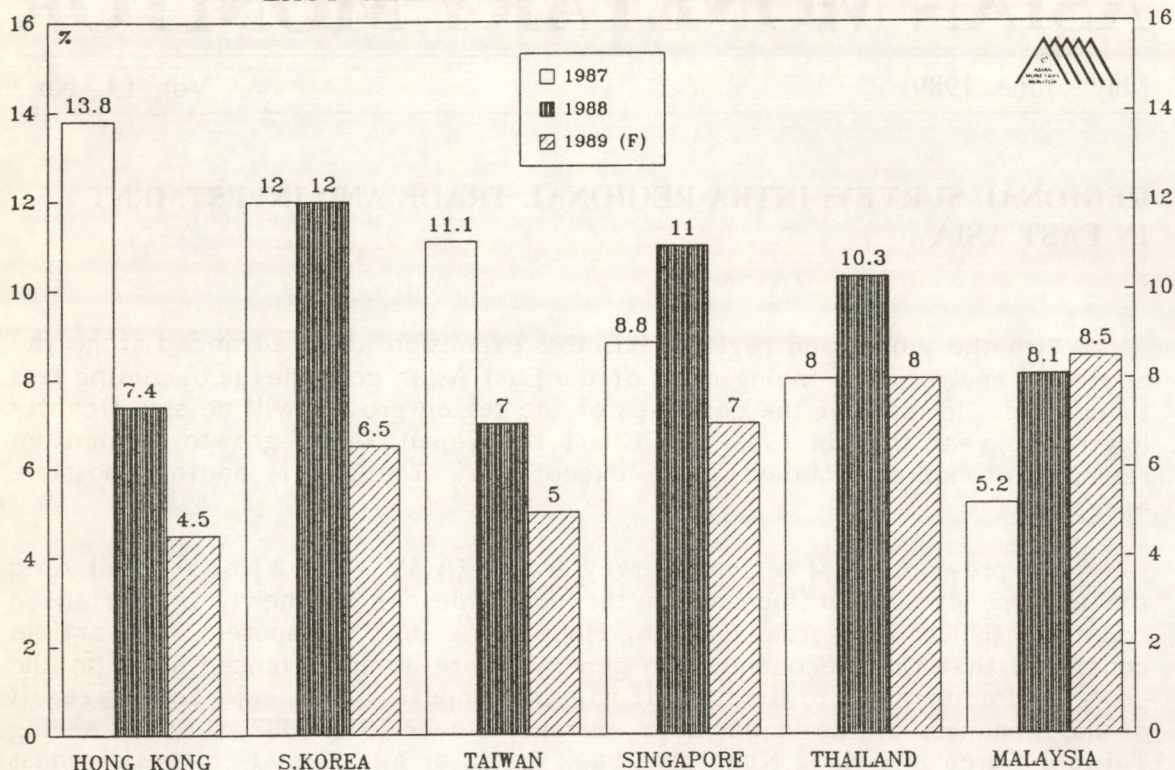
With the global and regional business expansion at an advanced stage the economic environment facing most of the East Asian countries is becoming less favourable. In most of the countries of the region growth will be significantly lower this year than in 1988 (see Chart 1). Japan, where growth momentum remains strong, and Malaysia are exceptions. Thailand is another possible exception.

The previous AMM regional survey article (AMM Vol. 12 No. 5) highlighted the adverse cyclical influences on the economies of the newly industrialised countries (NICs) of Korea, Taiwan, Hong Kong and Singapore. The article concluded that these economies, in general, were at an advanced stage in the process of adjustment to the one-off gain in competitiveness enjoyed as a result of the weakness of the 'dollar-bloc' currencies over 1985-1987, which is seeing Taiwan, Korea and Hong Kong give back much, or all, of that competitiveness gain through currency revaluation and/or inflation. The article also pointed to the additional negatives of the NICs' vulnerability to further weakness in US domestic demand - particularly applicable to Hong Kong - and the concern that the US dollar might ultimately begin to rise on the foreign exchanges, leading to rising NICs' currencies versus the yen and European currencies and further eroding their competitiveness.

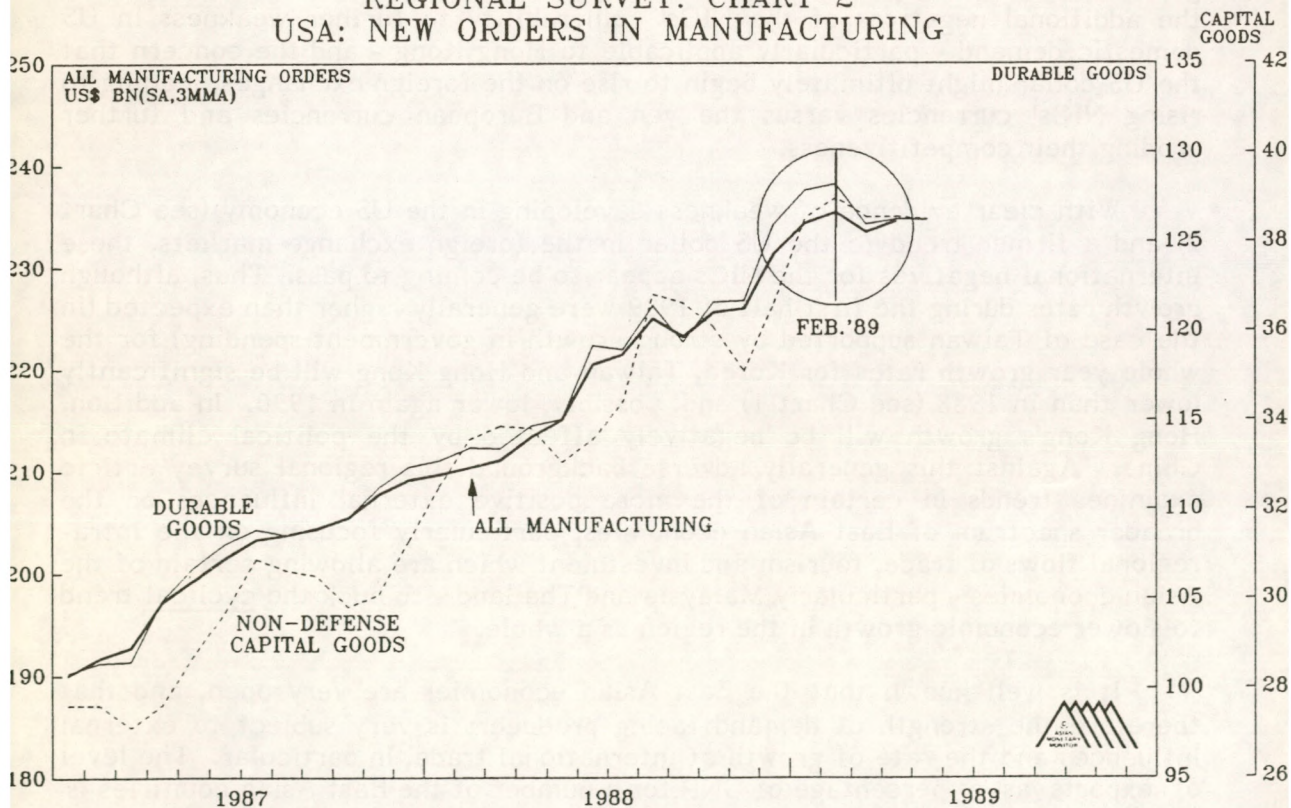
With clear evidence of weakness developing in the US economy (see Chart 2) and a firmer trend to the US dollar in the foreign exchange markets, these international negatives for the NICs appear to be coming to pass. Thus, although growth rates during the first half of 1989 were generally higher than expected (in the case of Taiwan supported by strong growth in government spending) for the whole year growth rates for Korea, Taiwan and Hong Kong will be significantly lower than in 1988 (see Chart 1) and, possibly, lower again in 1990. In addition, Hong Kong's growth will be negatively affected by the political climate in China. Against this generally adverse background this regional survey article examines trends in certain of the more positive external influences on the broader spectrum of East Asian economies, particularly focusing on the intra-regional flows of trade, tourism and investment which are allowing certain of the Asian economies - particularly Malaysia and Thailand - to buck the cyclical trend to slower economic growth in the region as a whole.

It is well known that the East Asian economies are very open, and that therefore the strength of demand facing producers is very subject to external influences and the rate of growth of international trade, in particular. The level of exports as a percentage of GNP for a number of the East Asian countries is

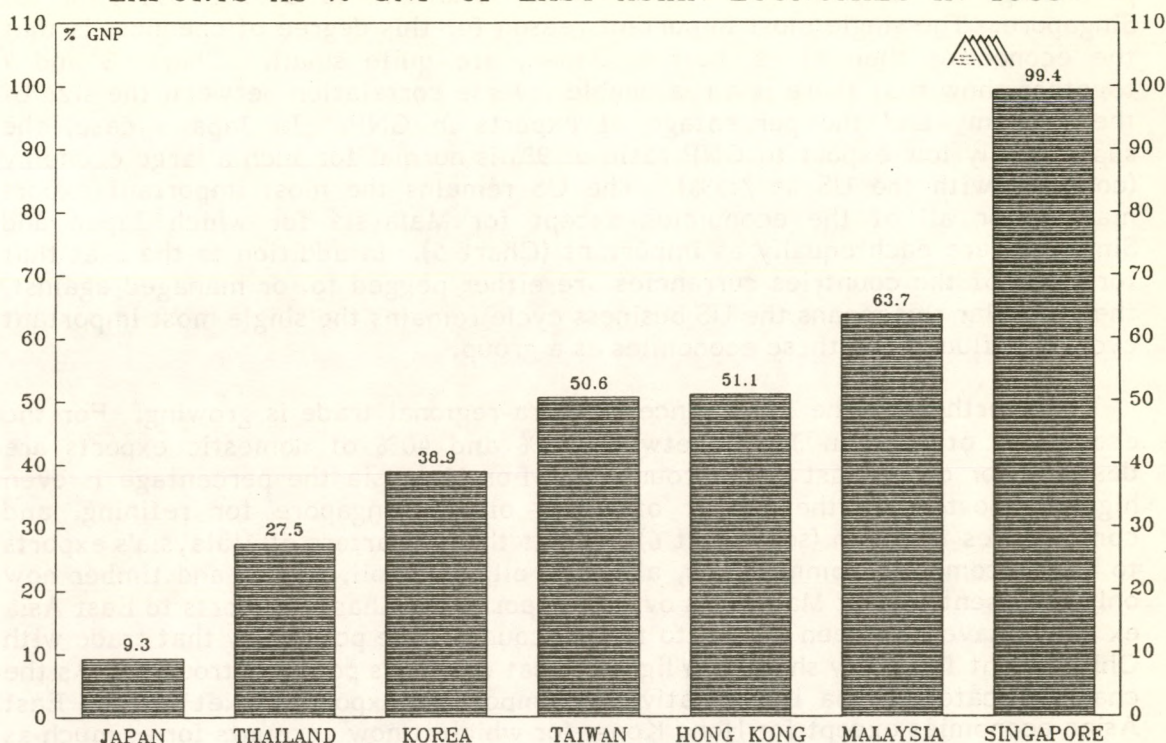
REGIONAL SURVEY: CHART 1 EAST ASIAN ECONOMIC GROWTH RATES



REGIONAL SURVEY: CHART 2 USA: NEW ORDERS IN MANUFACTURING

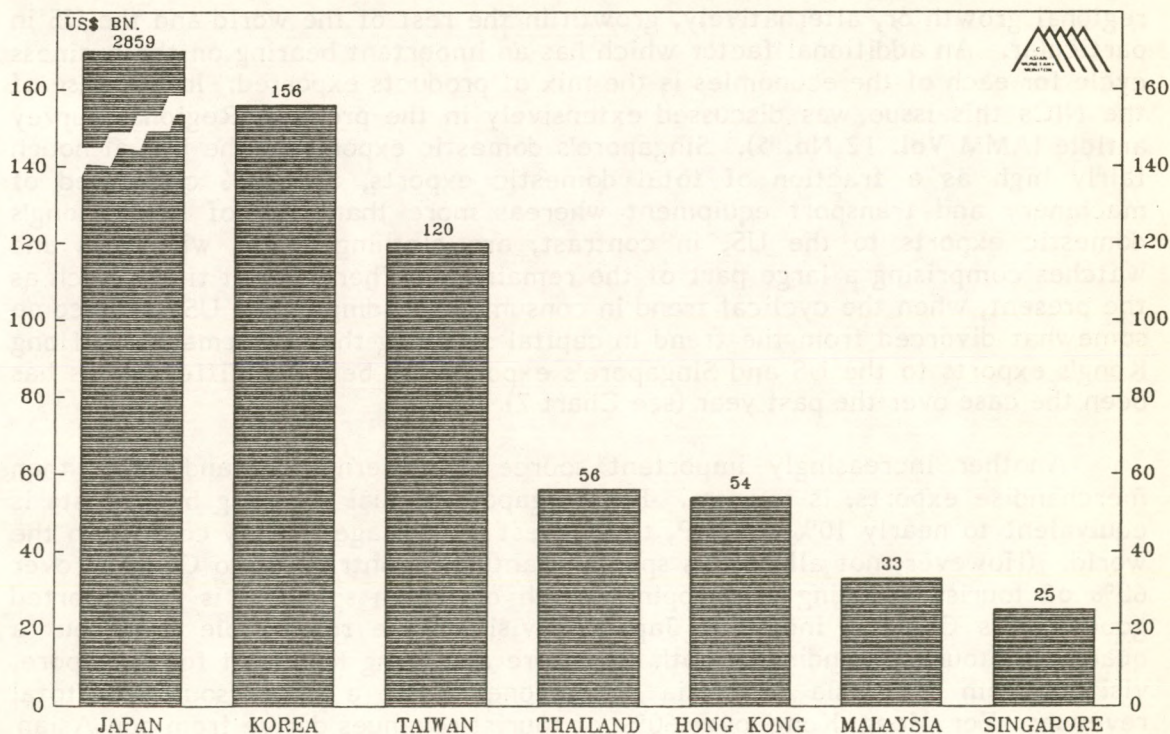


REGIONAL SURVEY: CHART 3 EXPORTS AS % GNP OF EAST ASIAN ECONOMIES IN 1988



NOTE: DOMESTIC EXPORTS FOR SINGAPORE AND HONG KONG

REGIONAL SURVEY: CHART 4 GNP OF EAST ASIAN ECONOMIES IN 1988



shown in Chart 3. For the economies other than Japan (domestic) exports as a percentage of GNP range from 28% for Thailand to as high as 99% for Singapore. The single most important reason for this degree of openness is that the economies themselves, barring Japan, are quite small. Charts 3 and 4 together show that there is a reasonable inverse correlation between the size of the economy and the percentage of exports in GNP. In Japan's case, the superficially low export to GNP ratio of 9% is normal for such a large economy (compare with the US at 7.5%). The US remains the most important export market for all of the economies except for Malaysia for which Japan and Singapore are each equally as important (Chart 5). In addition to the fact that for most of the countries currencies are either pegged to, or managed against, the US dollar this means the US business cycle remains the single most important cyclical influence on these economies as a group.

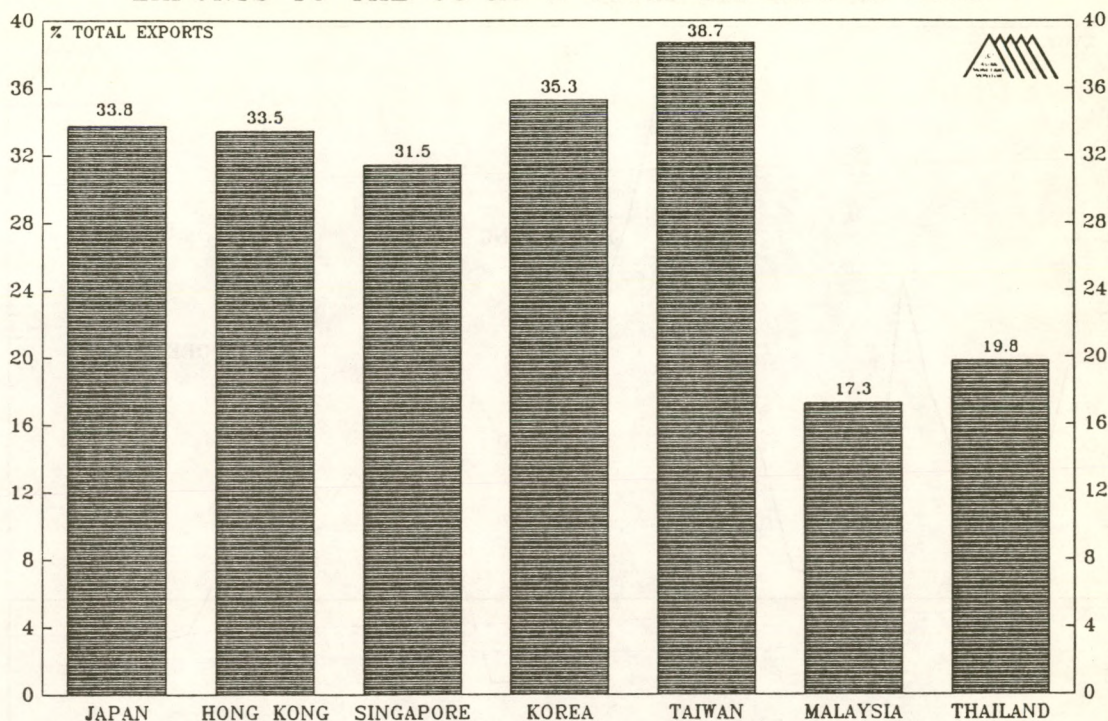
Nevertheless, the importance of intra-regional trade is growing. For the economies other than Japan between 30% and 40% of domestic exports are destined for other East Asian countries. For Malaysia the percentage is even higher, boosted by the export of crude oil to Singapore for refining, and commodities to Japan (see Chart 6). About three-quarters of Malaysia's exports to Japan comprise commodities, although oil, palm oil, rubber and timber now only represent 36% of Malaysia's overall exports. In Chart 6 exports to East Asia ex China have also been shown, to take account of the possibility that trade with China might fall away sharply in light of that country's political troubles. As the chart indicates, China is a relatively unimportant export market for the East Asian economies except for Hong Kong, for which it now accounts for as much as 17.5% of total domestic exports.

Charts 5 and 6 together provide some indication of the extent to which export demand for each of the East Asian countries is more of a function of regional growth or, alternatively, growth in the rest of the world and the US in particular. An additional factor which has an important bearing on the business cycle for each of the economies is the mix of products exported. In the case of the NICs this issue was discussed extensively in the previous Regional Survey article (AMM Vol. 12 No. 5). Singapore's domestic exports to the US, although fairly high as a fraction of total domestic exports, are 75% comprised of machinery and transport equipment whereas more than 40% of Hong Kong's domestic exports to the US, in contrast, are clothing items, with toys and watches comprising a large part of the remainder. Therefore at times, such as the present, when the cyclical trend in consumer spending in the US has become somewhat divorced from the trend in capital spending the performance of Hong Kong's exports to the US and Singapore's exports can be quite different, as has been the case over the past year (see Chart 7).

Another increasingly important source of external demand other than merchandise exports, is tourism. For Singapore annual spending by tourists is equivalent to nearly 10% of GNP, the highest percentage for any country in the world. (However, not all of this spending actually contributes to GNP, as over 60% of tourist spending is shopping, much of which spending is on imported goods.) As Chart 9 indicates Japanese visitors are responsible for about a quarter of tourist spending in both Singapore and Hong Kong but for Singapore, visitors from S.E. Asia (Malaysia and Indonesia) are a larger source of total revenues. For Hong Kong over 60% of tourist revenues derive from non-Asian

REGIONAL SURVEY: CHART 5

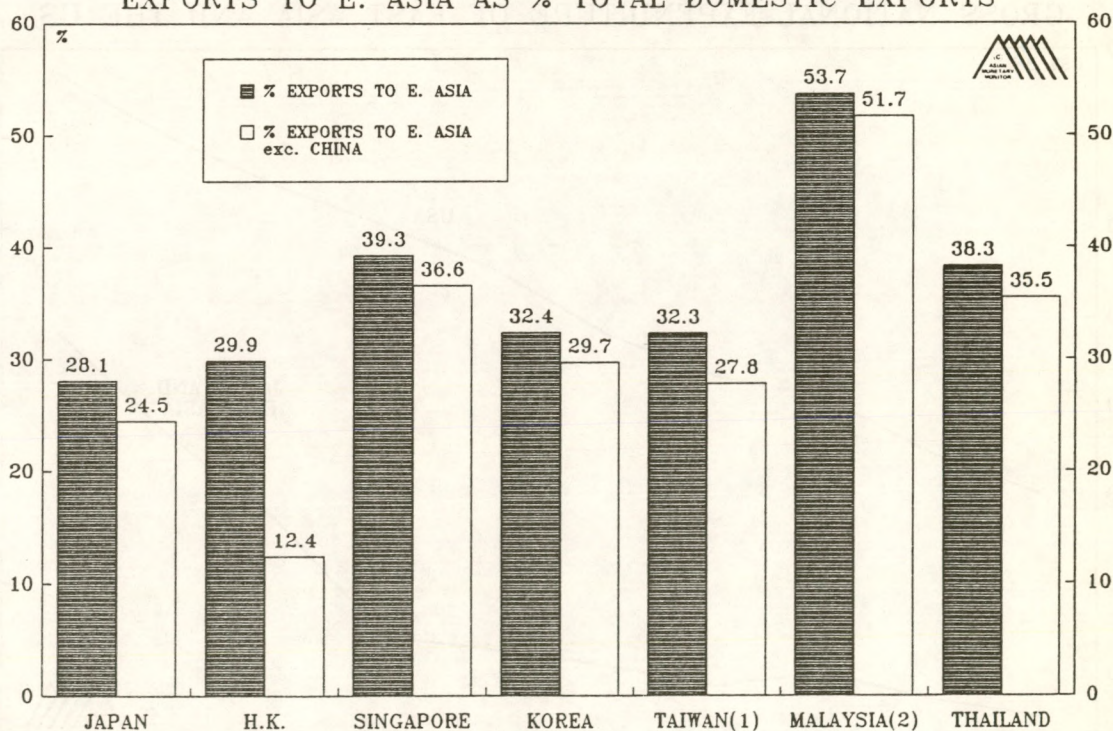
EXPORTS TO THE US AS % TOTAL EXPORTS IN 1988



NOTE: DATA FOR HONG KONG AND SINGAPORE REFERS TO DOMESTIC EXPORTS

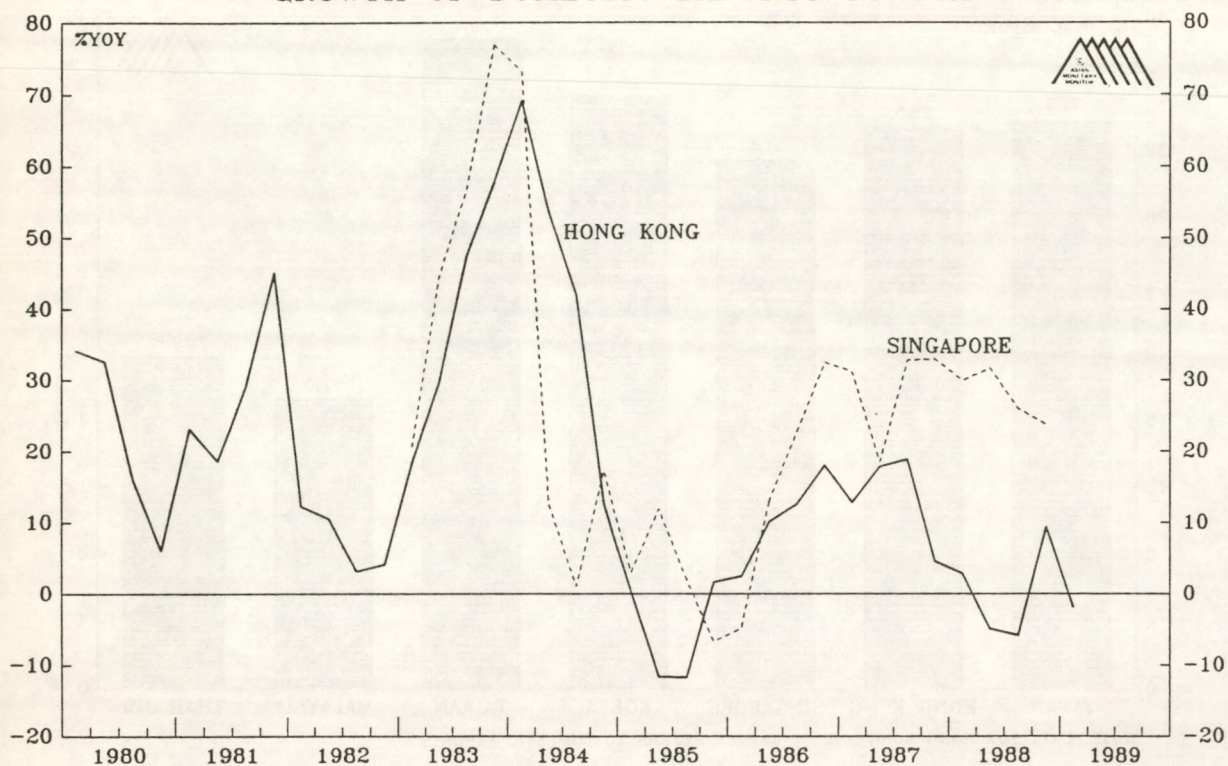
REGIONAL SURVEY: CHART 6

EXPORTS TO E. ASIA AS % TOTAL DOMESTIC EXPORTS

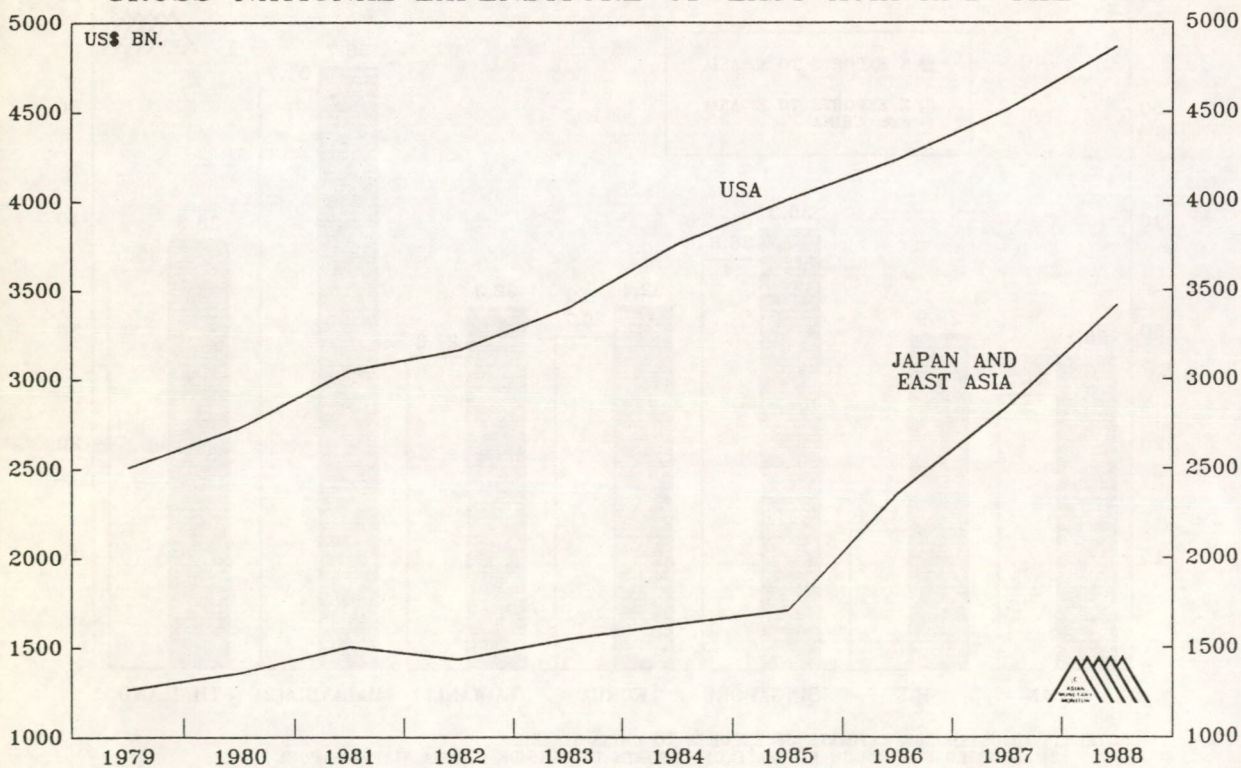


NOTE: (1) ADJUSTED FOR ESTIMATE OF EXPORTS TO CHINA VIA H.K.
 (2) ADJUSTED FOR ROUGH ESTIMATE OF EXPORTS TO OUTSIDE E. ASIA VIA SINGAPORE

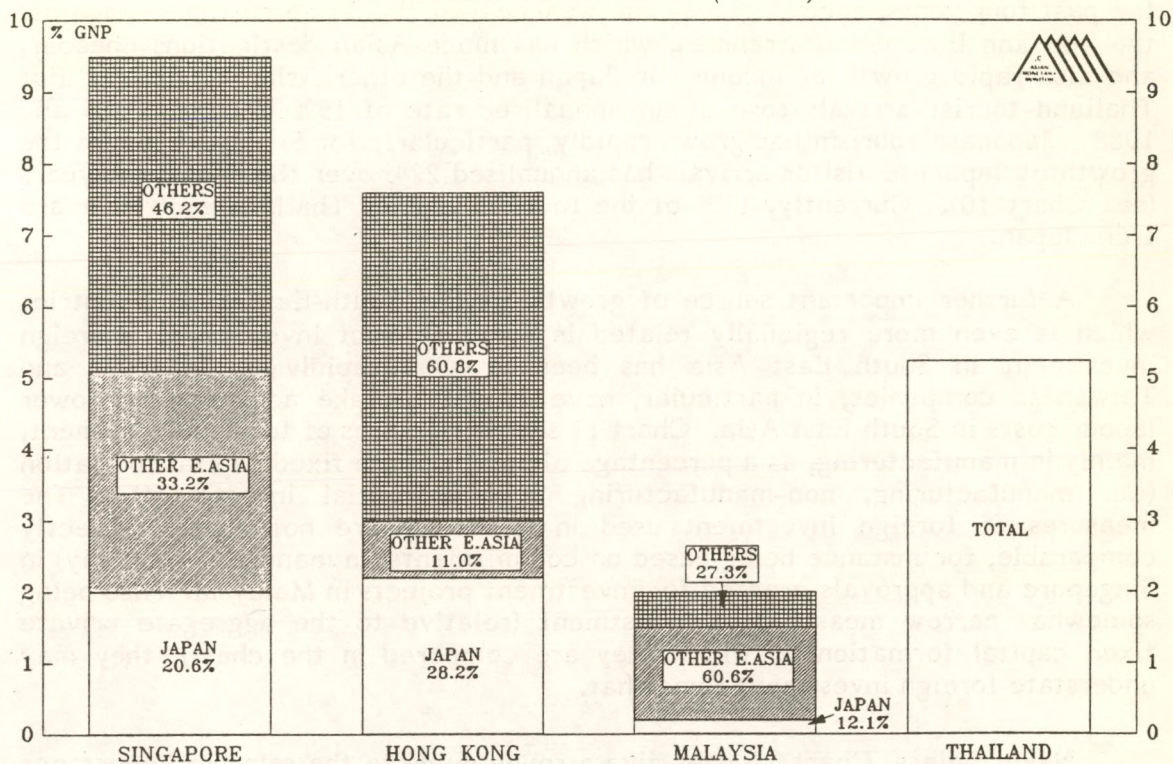
REGIONAL SURVEY: CHART 7
GROWTH OF DOMESTIC EXPORTS TO USA



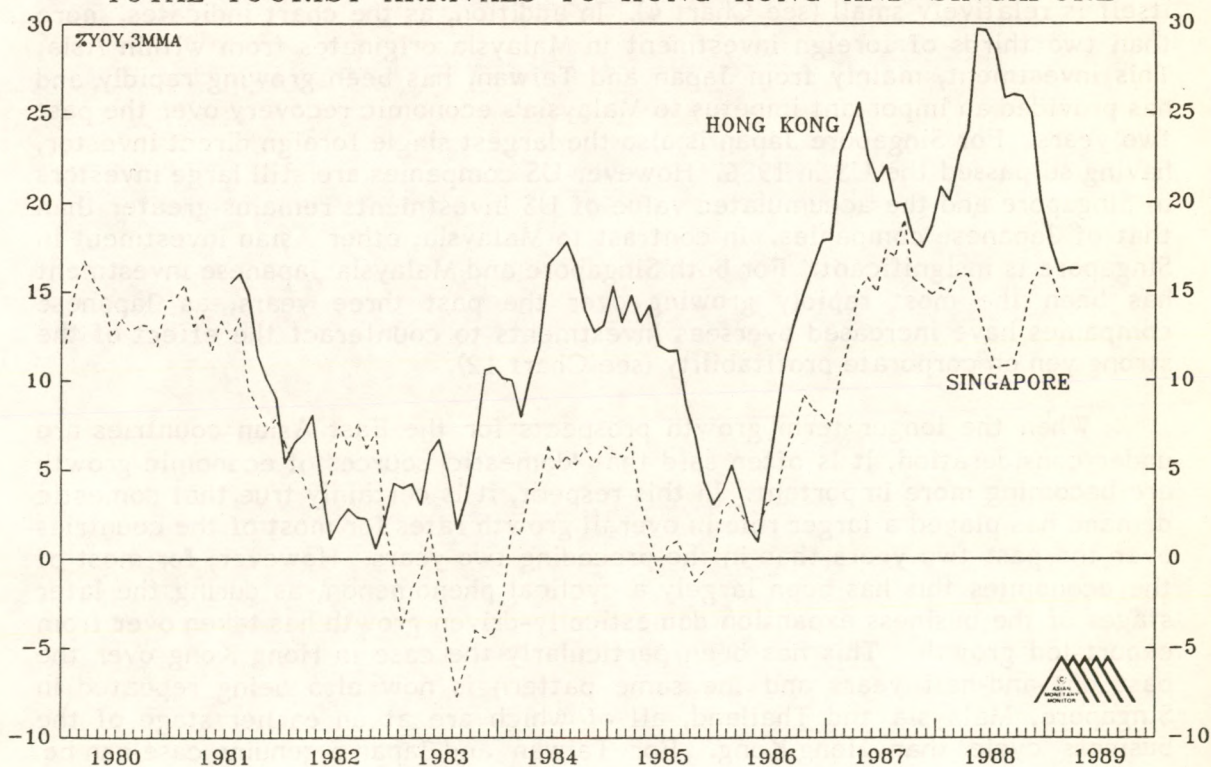
REGIONAL SURVEY: CHART 8
GROSS NATIONAL EXPENDITURE OF EAST ASIA AND THE US



REGIONAL SURVEY: CHART 9
TOURIST SPENDING (1988)



REGIONAL SURVEY: CHART 10
TOTAL TOURIST ARRIVALS TO HONG KONG AND SINGAPORE



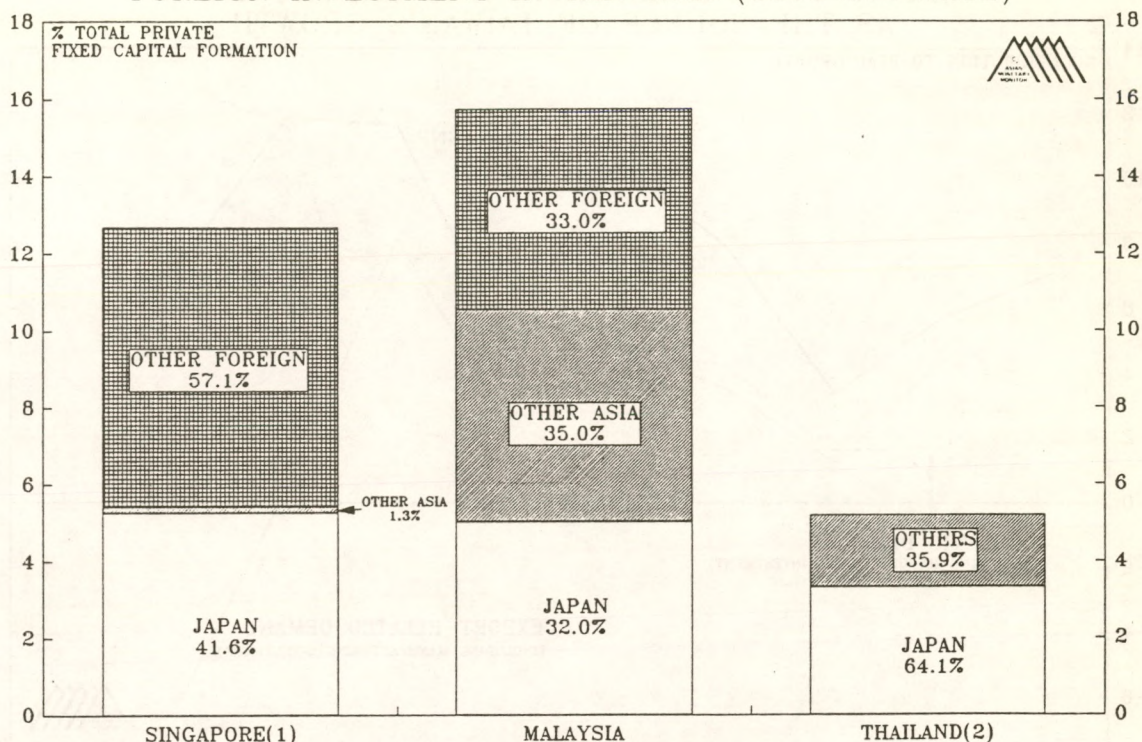
tourism, a significant part of which is China-related and will be affected by political developments in China. Tourism has increased particularly rapidly over the past four years, encouraged by the weakness of the Asian currencies against the yen and European currencies, which has made Asian destinations cheaper, and also rapid growth of incomes in Japan and the other Asian countries. For Thailand tourist arrivals rose at an annualised rate of 19% between 1985 and 1988. Japanese tourism has grown rapidly, particularly for Singapore where the growth of Japanese visitor arrivals has annualised 22% over the past three years (see Chart 10). Currently, 11% of the tourists visiting Thailand each year are from Japan.

A further important source of growth for the South-East Asian countries which is even more regionally related is foreign direct investment. Foreign investment in South East Asia has been growing rapidly as Japanese and Taiwanese companies, in particular, have sought to take advantage of lower labour costs in South East Asia. Chart 11 shows measures of foreign investment, mainly in manufacturing, as a percentage of total private fixed capital formation (i.e. manufacturing, non-manufacturing and residential investment). The measures of foreign investment used in Chart 11 are not strictly directly comparable, for instance being based on commitments (in manufacturing only) in Singapore and approvals granted for investment projects in Malaysia. Also being somewhat narrow measures of investment (relative to the aggregate private fixed capital formation to which they are compared in the chart), they may understate foreign investment somewhat.

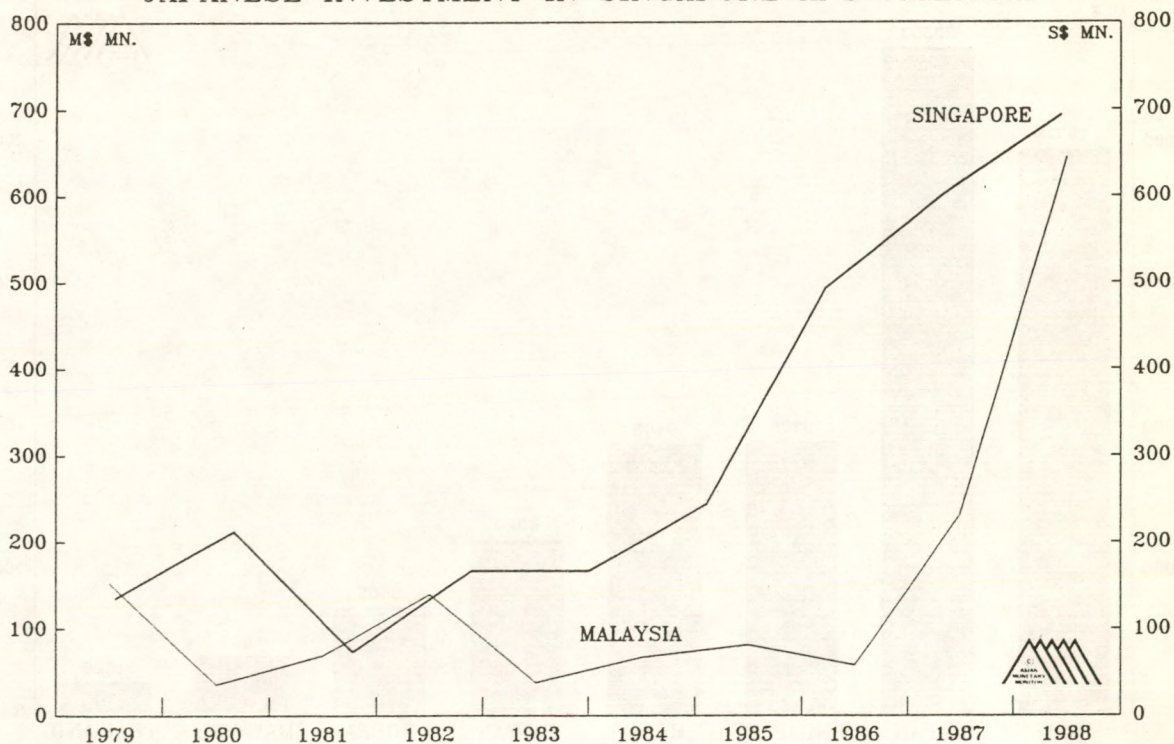
Nevertheless, Chart 11 does give a rough guide to the relative importance of foreign investment to each economy. For Malaysia foreign investment is particularly large in relation to total investment, partly because the economy itself is relatively small (see Chart 4). In addition, as the chart indicates, more than two thirds of foreign investment in Malaysia originates from within Asia. This investment, mainly from Japan and Taiwan, has been growing rapidly and has provided an important impetus to Malaysia's economic recovery over the past two years. For Singapore Japan is also the largest single foreign direct investor, having surpassed the US in 1986. However US companies are still large investors in Singapore and the accumulated value of US investments remains greater than that of Japanese companies. In contrast to Malaysia, other Asian investment in Singapore is insignificant. For both Singapore and Malaysia Japanese investment has been the most rapidly growing over the past three years, as Japanese companies have increased overseas investments to counteract the effect of the strong yen on corporate profitability (see Chart 12).

When the longer term growth prospects for the East Asian countries are under consideration, it is often said that 'domestic' sources of economic growth are becoming more important. In this respect, it is certainly true that domestic demand has played a larger role in overall growth rates for most of the countries over the past two years than in the preceding two years. However, for most of the economies this has been largely a cyclical phenomenon, as during the later stages of the business expansion domestically-driven growth has taken over from export-led growth. This has been particularly the case in Hong Kong over the past one-and-a-half years and the same pattern is now also being repeated in Singapore, Malaysia and Thailand, all of which are at an earlier stage of the business cycle than Hong Kong. For Taiwan and Japan a genuine case can be

REGIONAL SURVEY: CHART 11
FOREIGN INVESTMENT IN S.E. ASIA (1988 ESTIMATE)

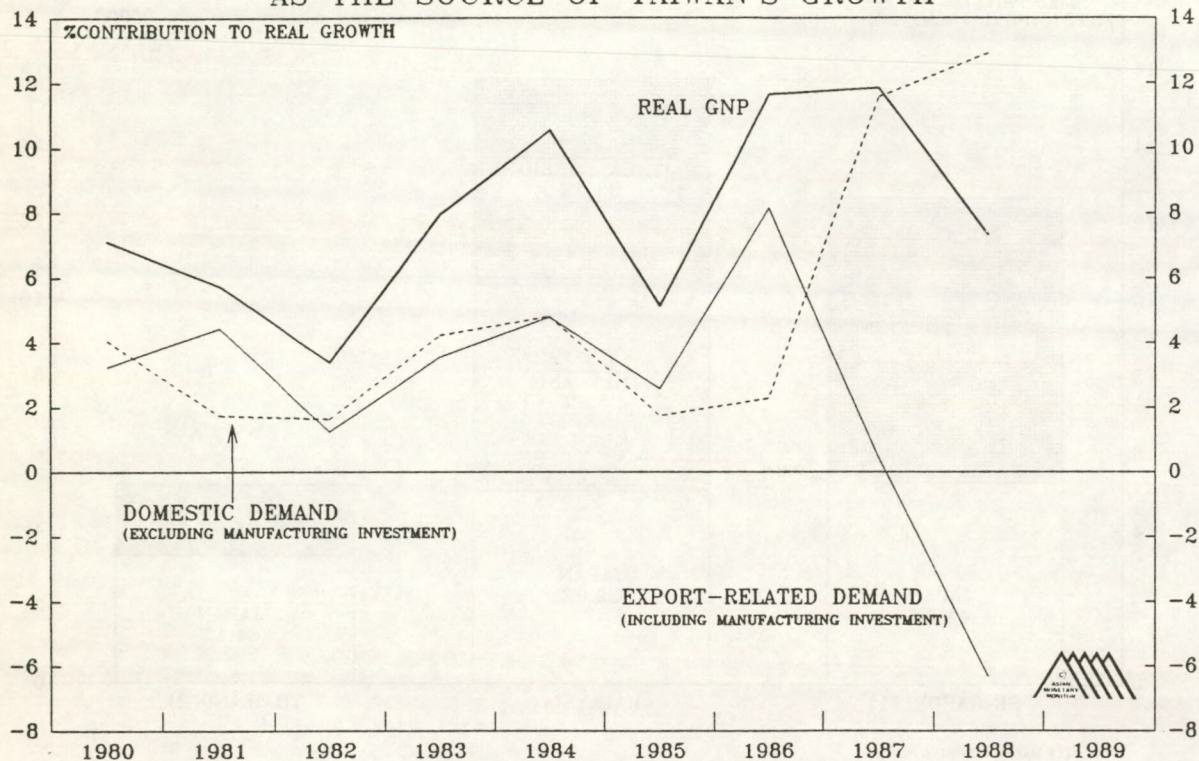


REGIONAL SURVEY: CHART 12
JAPANESE INVESTMENT IN SINGAPORE AND MALAYSIA



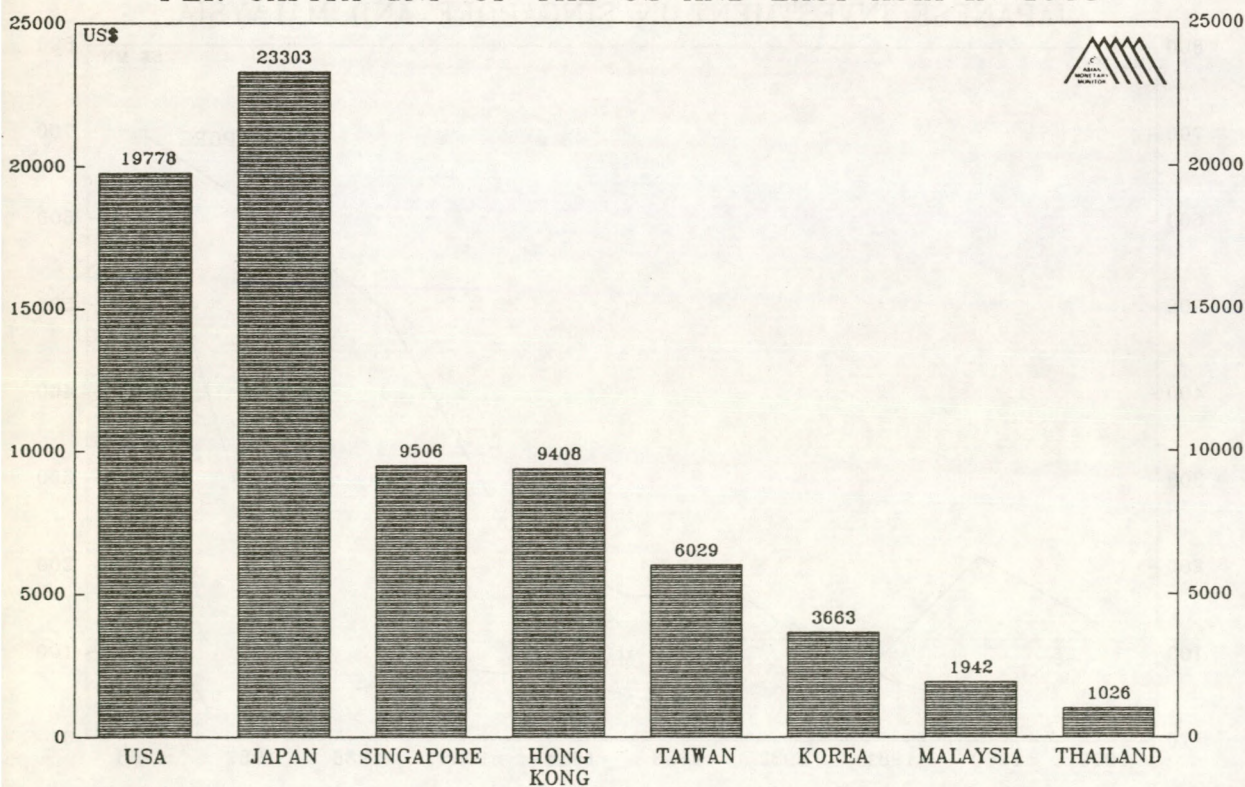
REGIONAL SURVEY: CHART 13

DOMESTIC DEMAND HAS REPLACED EXPORT DEMAND AS THE SOURCE OF TAIWAN'S GROWTH



REGIONAL SURVEY: CHART 14

PER CAPITA GNP OF THE US AND EAST ASIA IN 1988



made that the greater importance of domestic sources of growth is also reflecting a secular change arising out of gradual liberalisation and deregulation of their respective economies, which have allowed those countries to move on to a somewhat higher growth path than would otherwise have been possible. In general, however, over the very long term the growth rate depends on the growth in the labour force, capital stock and achievable factor productivity. As the Asian economies become richer growth rates will tend to slow a little as productivity increases become harder to achieve as the economies become more service-oriented. In this respect, it should be expected, particularly now that growth momentum has been established, that the relatively poorer countries of Thailand and Malaysia will be able to achieve higher growth rates than the more developed economies of the NICs over the very long term (see Chart 14).

FORECAST: Over the longer-run the East Asian region will continue to be a rapidly growing area. Singapore (tourism, Japanese investment) and Malaysia (trade and Asian direct investment) are the two economies which benefit most from the rapid growth of the East Asian region itself, with Malaysia likely to be the more rapidly growing of the two over the longer term simply because it is starting from a 'lower base'. Thailand also is a significant beneficiary of Asian investment and tourism.

Looking at the current business cycle, for the next one or two years Malaysia is also particularly well positioned because, apart from being much less vulnerable to the slowdown of the US economy than the other countries, and still experiencing growing inflows of foreign direct investment, it is also at a much earlier stage of its business expansion than the other Asian economies, having taken longer to recover from the East Asian recession of 1985. At the other extreme, Hong Kong is relatively highly dependent on exports of consumer goods to the US and also trade and tourism from outside of Asia which is related to China. Given the weakening trends of the US economy, and also the Chinese economy in the wake of recent political developments (see the capsule in this AMM), Hong Kong is likely to experience significantly lower growth over the next year.

Clearly other factors are also at work in determining shorter-term growth rates, particularly those factors which affect competitiveness discussed in the regional survey of AMM Vol. 12 No. 5. Competitiveness factors continue to favour Singapore which still enjoys a low inflation rate and, unlike Taiwan and Korea, has not significantly revalued its currency vis-a-vis the US dollar. Singapore also benefits from the high weighting of capital goods in its domestic exports, particularly in exports to the US, which will continue to be a positive factor for Singapore's growth for as long as worldwide capital spending remains strong.

HONG KONG: FURTHER DEVELOPMENTS AFFECTING THE LINKED RATE SYSTEM FOR THE HONG KONG DOLLAR

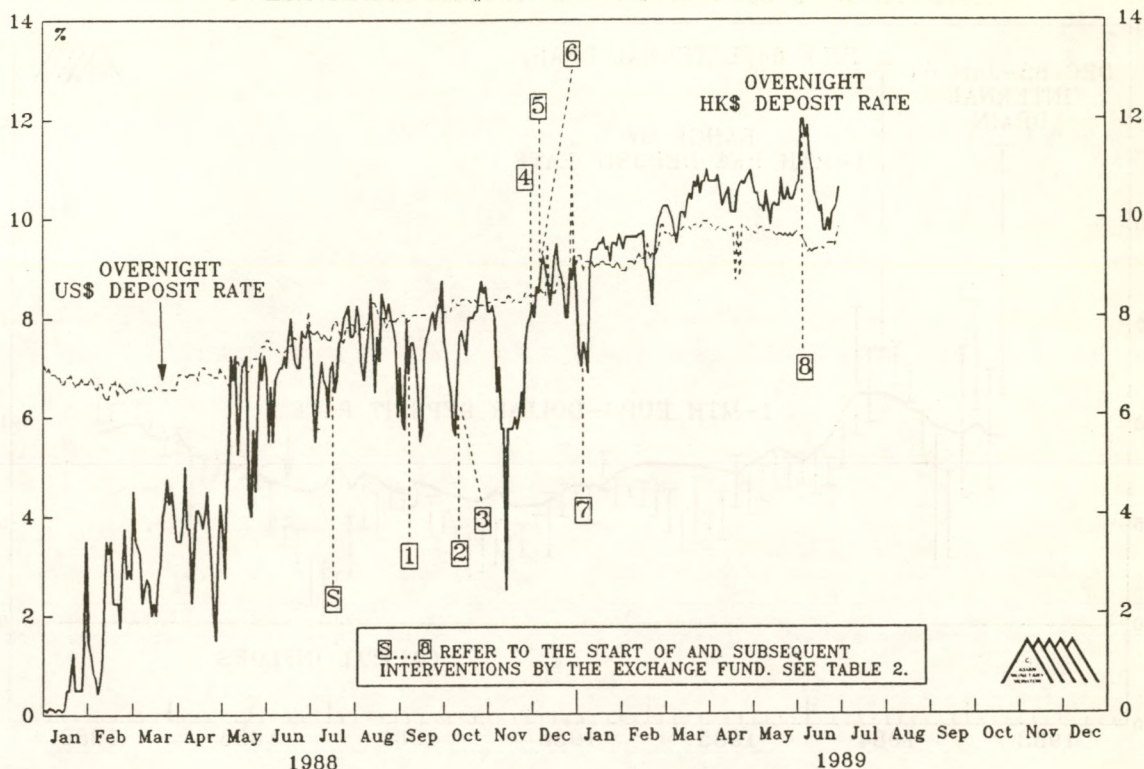
There are two types of "test" to which the linked rate for the Hong Kong dollar can be subjected. First, there is the internal drain, i.e. the conversion of HK\$ deposits into HK\$ currency on a large scale and, second there is the external drain, i.e. the conversion of HK\$ deposits into foreign currency in substantial amounts. In the early days of June there was the possibility that the linked rate mechanism could be subjected to both types of test.

On June 5th and 6th in the wake of the Tiananmen massacre Hong Kong residents showed their disgust at the conduct of the PRC government by making substantial withdrawals of deposits and cash from the Bank of China and its affiliated banks in Hong Kong. The reduction in deposits at the Bank of China and its sister banks would have caused those banks to experience overdrafts on their balances at the Clearing House. If those overdrafts had become too large, it is quite possible that instead of becoming excessively overdrawn with the Hongkong and Shanghai Banking Corporation (which operates the Clearing House), arrangements could have been made for other banks to have extended loans to the Bank of China group. The withdrawals of cash - the traditional form of the internal drain - from the Bank of China group would have led to the kind of consequences described in the January-February 1984 issue of AMM (page 4). Briefly, in this case the Bank of China's loss of cash and hence deposits would have further increased its overdrafts at the Clearing House. In addition, the Bank of China would have been obliged to purchase HK\$ banknotes with US\$ - possibly drawing on gold or other non Hong Kong dollar foreign currency assets - from one of the two note-issuing banks in Hong Kong in order to satisfy its customers' demand for cash. Since the Bank of China could not have called in its normal loans and advances sufficiently rapidly to meet the cash or deposit drain it would have been forced to borrow additional funds in the money market thus causing interest rates in Hong Kong to rise. As a result overnight interbank rates rose from 10% to 12% between June 5 and 8, about 3% above the overnight Eurodollar equivalent for US\$. (See Chart 1). At the same time the Hong Kong dollar rose to a 2 cent premium (7.78) relative to its parity of 7.80. (See Chart 2).

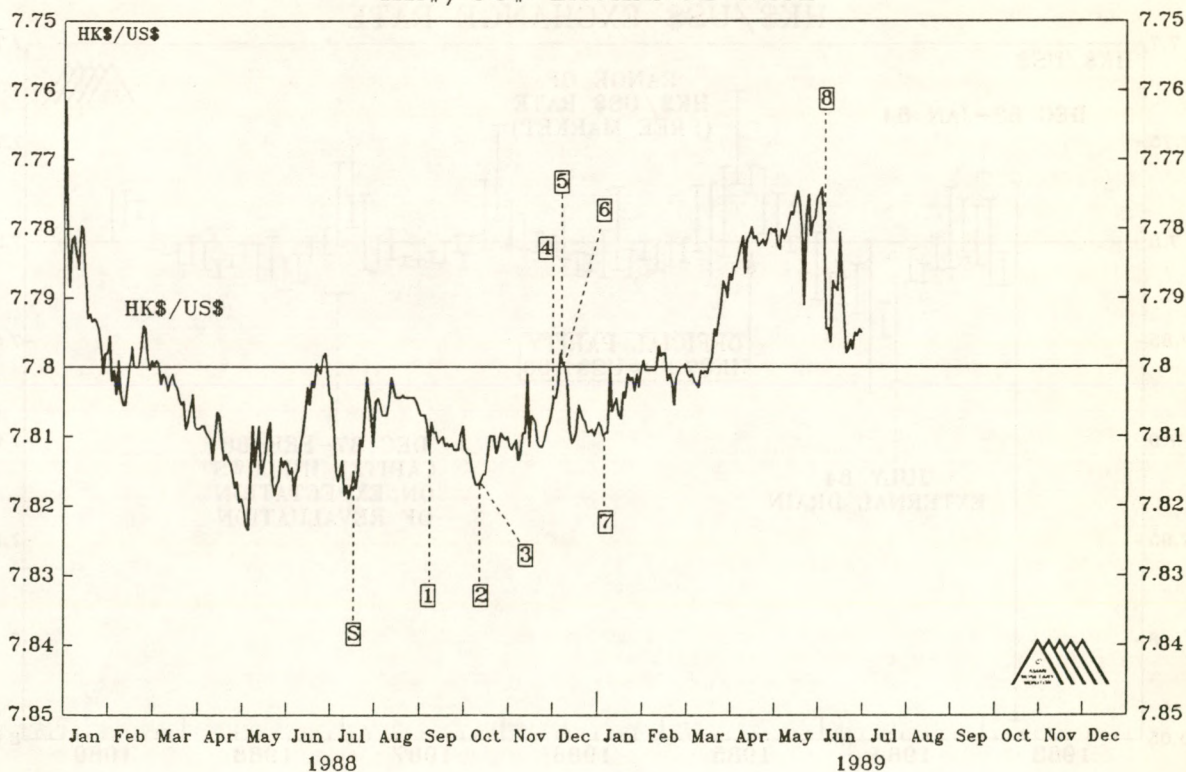
This mechanism is precisely similar to the chain of events which occurred at Christmas and New Year 1983/84 just after the linked rate system for the Hong Kong dollar was established (see Charts 3 and 4) when there was a large demand for cash from the public for the first time under the new system. Since banks had failed to anticipate the effects of the cash drain at this time interest rates rose sharply, and the Hong Kong dollar moved up to a premium relative to the parity. In subsequent years the banking system has learned to cope with seasonal cash drains of this kind, but the kind of cash drain which occurred on June 5th and 6th 1989 was clearly unexpected and therefore could not have been anticipated by appropriate portfolio actions.

In the immediate aftermath of the withdrawals of deposits from the Bank of China it was unlikely that the internal drain would cause any serious problems

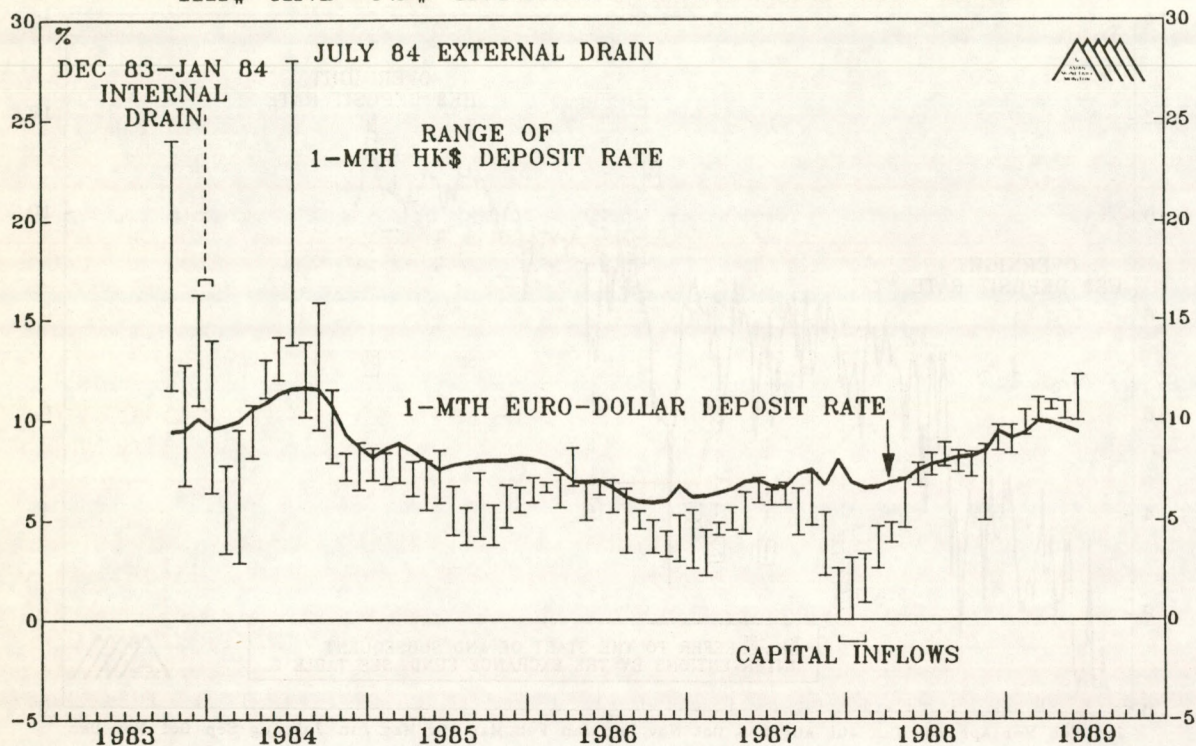
HONG KONG: CHART 1 OVERNIGHT HK\$ AND US\$ INTEREST RATE



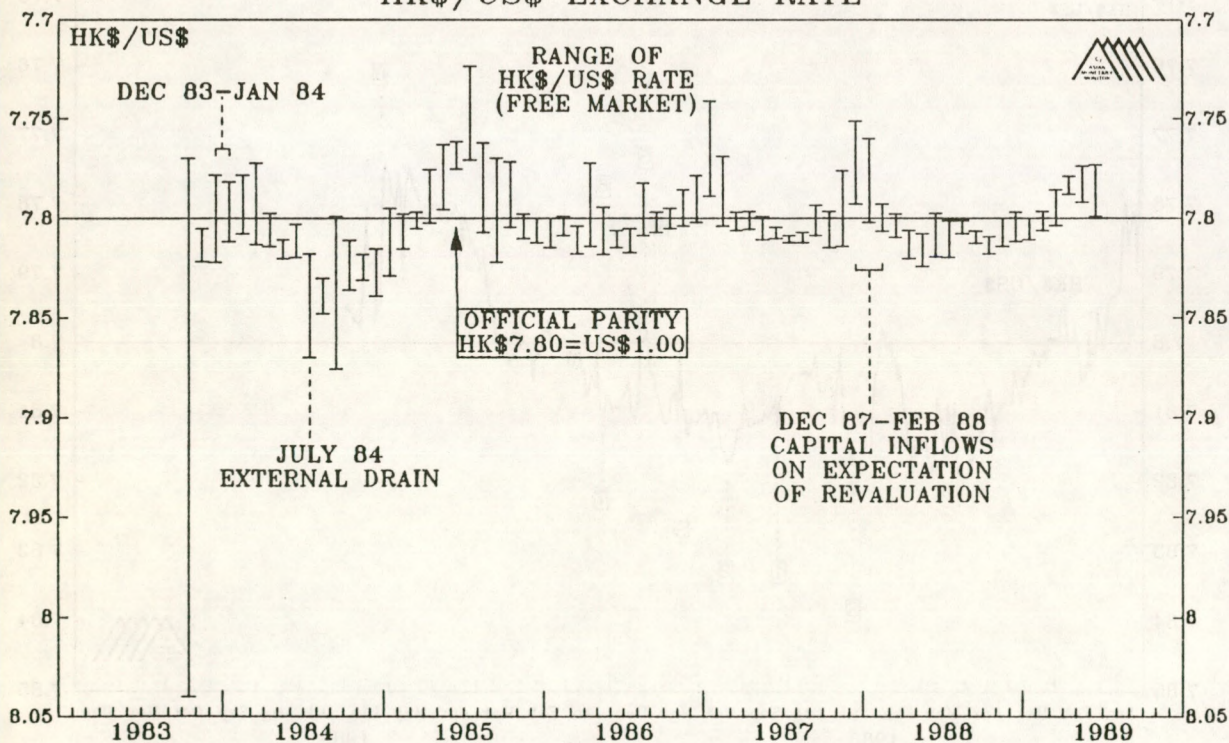
HONG KONG: CHART 2 HK\$/US\$ EXCHANGE RATE



HONG KONG: CHART 3 HK\$ AND US\$ INTEREST RATE DIFFERENTIALS



HONG KONG: CHART 4 HK\$/US\$ EXCHANGE RATE



for the linked rate system because funds from the Bank of China were, for the most part, being re-deposited with other banks in Hong Kong, so that the overall HK\$ money supply remained largely unchanged. To date there has been no significant evidence of the second type of problem, namely the external drain. However, if the crisis in China had continued or worsened then it is quite possible that there would have been outflows of funds as there were in July 1984 for example. Charts 3 and 4 show how during that episode the Hong Kong dollar fell to around 7.87 while one month interbank HK\$ deposit rates rose to 28%.

The key difference between an internal drain and an external drain can be illustrated by considering what happens to the free market exchange rate under each set of circumstances. In the case of an internal drain, interest rates rise and the free market rate for the HK\$ goes to a premium relative to the parity, e.g. 7.75, but in the case of an external drain the HK\$ goes to a discount relative to the parity, e.g. 7.85, while again interest rates rise. Throughout most of the recent June 1989 episode the HK\$ remained at a premium to the parity which suggests that the internal drain dominated the external drain.

The linked rate system has withstood both kinds of attack - internal and external drains - before, and one can be reasonably confident that it will easily withstand either the internal drain or the external drain, or a combination of the two, in future. Basically, the HK\$ is simply a different denomination of the US\$, but during episodes of internal or external drain it yields a higher rate of interest than US\$.

The only major qualification which needs to be made to all of the statements above is that since July 1988 the Exchange Fund has been operating more like a central bank than a passive colonial currency board. (See AMM Vol. 12 No. 4 July-August 1988, "Intervention Replaces Arbitrage - The July Package of Monetary Measures" for details of the new arrangements). Between July 1988 and June 1989 there have been eight episodes of intervention by the Exchange Fund using the new machinery, as shown in Table 2. The timing of each episode of intervention is also pinpointed by the numbers shown on Charts 1 and 2. The interventions have either been conducted with the aim of keeping the free market rate for the Hong Kong dollar within some unspecified band on each side of the 7.80 parity, or in some cases to manage money market interest rates. One example of intervention aimed at money market management was the injection and subsequent withdrawal of HK\$ 200 million at the time of the Hong Kong Telecom share issue in December 1988. When the Bank of China found itself in difficulties on June 5th and 6th the Hong Kong authorities were quick to intervene again with an injection of funds into the system. This time the injection was HK\$ 194 million. Thus instead of allowing the internal drain or external drain to run their full course, the Hong Kong authorities are regularly intervening to offset the consequences of natural market forces. On the surface the scale of intervention has been quite small, but it should always be remembered that the impact on the banking system as a whole is potentially many times greater than the size of the intervention itself. To gauge the impact one must calculate the monetary multiplier and apply that to the amount of the intervention as shown in Tables 1 and 2.

TABLE 1

MONETARY MULTIPLIERS FOR HONG KONG FROM JULY 1988

	<u>HK\$M1</u>	<u>HK\$M3</u>	<u>C</u>	<u>A</u>	<u>Base</u>	<u>HK\$M1</u> Base	<u>HK\$M3</u> Base
<u>1988</u>							
July	73,188	356,457	30,977	1250	32,227	2.27	11.06
Aug	73,834	355,204	30,899	1250	32,149	2.30	11.05
Sept	75,009	357,261	31,549	1100	32,649	2.30	10.94
Oct	77,725	372,052	31,895	880	32,775	2.37	11.33
Nov	78,698	387,345	32,298	860	33,158	2.37	11.68
Dec	79,257	389,052	34,087	860	34,947	2.27	11.13
<u>1989</u>							
Jan	87,362	401,177	39,975	728	40,703	2.15	9.86
Feb	82,844	400,052	36,415	728	37,143	2.15	9.86
Mar	80,623	401,505	35,766	728	36,494	2.21	11.00
Apr	78,285	408,119	35,300	728	36,028	2.17	11.33
May				728			
June				922			

Notes: Monthend data in HK\$ millions
 C = Total Cash Currency Issued
 A = Level of funds in The Account. For consistency monthend data have been used to calculate the base.

TABLE 2

RECORD OF INTERVENTIONS BY THE EXCHANGE FUND SINCE JULY 1988

	<u>Outstanding Balance of The Account</u>	<u>Scale of Intervention</u>	<u>Approx. Impact on HK\$M1</u>	<u>Approx. Impact on HK\$M3</u>
<u>1988</u>				
S July 18	1250			
1. Sept. 7	1100	- 150	- 345	- 1650
2. Oct. 11	950	- 150	- 345	- 1650
3. Oct. 12	880	- 70	- 160	- 775
4. Nov. 30	860	- 20	- 50	- 235
5. Dec. 6	1060	+ 200	+ 460	+ 2100
6. Dec. 7	860	- 200	- 460	- 2100
<u>1989</u>				
7. Jan. 5	728	- 132	- 290	- 1390
8. June 5	922	+ 194	+ 445	+ 2150

Note : The multiplier is calculated as the average of the HK\$ money supply divided by total cash currency plus funds in The Account for the monthend immediately preceding and the monthend immediately after the specified intervention.

When the authorities introduced their "new accounting arrangements" in July 1988, they thereby changed the definition of the monetary base in Hong Kong. Before July the monetary base consisted only of cash currency held by the public and by the banks and deposit-taking companies (DTCs). Since the introduction of the new scheme the monetary base has consisted of cash currency held by the public and by the banks and DTCs plus the amount of funds required to be held to the account of the Hongkong and Shanghai Bank at the Exchange Fund. In symbols :

$$B = C + A$$

where B is the monetary base, C is the total currency issued, and A is the amount of funds in "The Account".

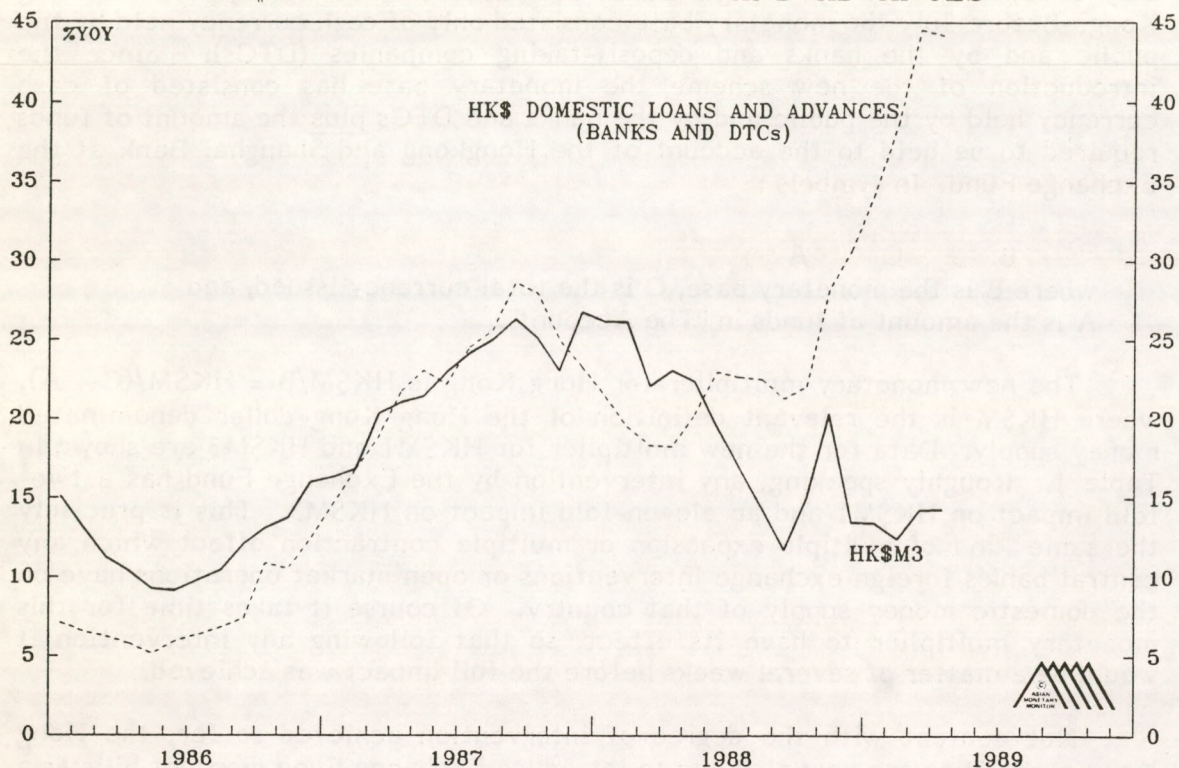
The new monetary multiplier for Hong Kong is $HK\$M/B = HK\$M/(C + A)$, where HK\$M is the relevant definition of the Hong Kong dollar denominated money supply. Data for the new multiplier for HK\$M1 and HK\$M3 are shown in Table 1. Roughly speaking, any intervention by the Exchange Fund has a two-fold impact on HK\$M1 and an eleven-fold impact on HK\$M3. This is precisely the same kind of multiple expansion or multiple contraction effect which any central bank's foreign exchange interventions or open market operations have on the domestic money supply of that country. Of course it takes time for this monetary multiplier to have its effect, so that following any intervention it would be a matter of several weeks before the full impact was achieved.

Not content with the degree of intervention achieved so far, the Hong Kong authorities are now planning to introduce Exchange Fund discount bills as a further monetary instrument to assist in their money market management operations. If transactions in the new bills are settled by debits or credits to The Account of the Hongkong and Shanghai Bank at the Exchange Fund then operations by the Exchange Fund in the new bills will have an equally powerful multiple expansion or multiple contraction effect on the banking system as a whole. However, if they are settled by debits and credits to the accounts of the Exchange Fund with the banking system, then they will not have more than a trivial impact on the volume of funds in the system.

Needless to say, with the expansion in Exchange Fund operations goes an expansion in staff, so the Exchange Fund is recruiting dealers for its foreign exchange and money market dealing room. This is to be accompanied by the appointment of recognised dealers or market-makers who will have to meet capital adequacy requirements similar to those in existence for banks and DTCs. With the development of this additional machinery it seems likely that Hong Kong will move to a system of regular discretionary intervention in the domestic money market and/or in the foreign exchange market. Once this is accomplished later this year it will no longer be possible to claim that Hong Kong does not have a central bank. All the important market operations of a central bank - i.e. foreign exchange intervention and domestic open market operations each with a full multiple expansion or multiple contraction effect - will be regularly conducted by the Exchange Fund. The Exchange Fund bills will be liabilities of the Fund rather than liabilities of the government or Treasury. The issue of this short term debt is therefore purely for monetary rather than fiscal purposes, though there is the secondary objective of helping to develop the

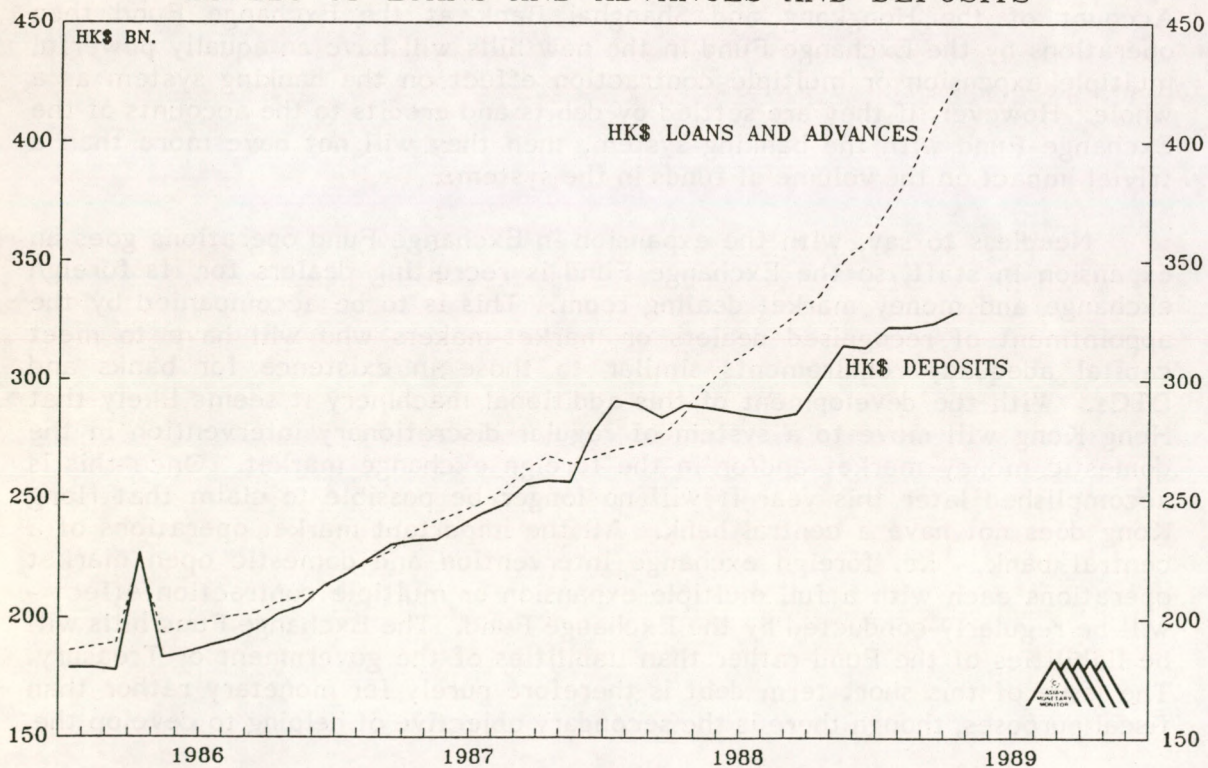
HONG KONG: CHART 5

HK\$M3 AND DOMESTIC LOANS AND ADVANCES

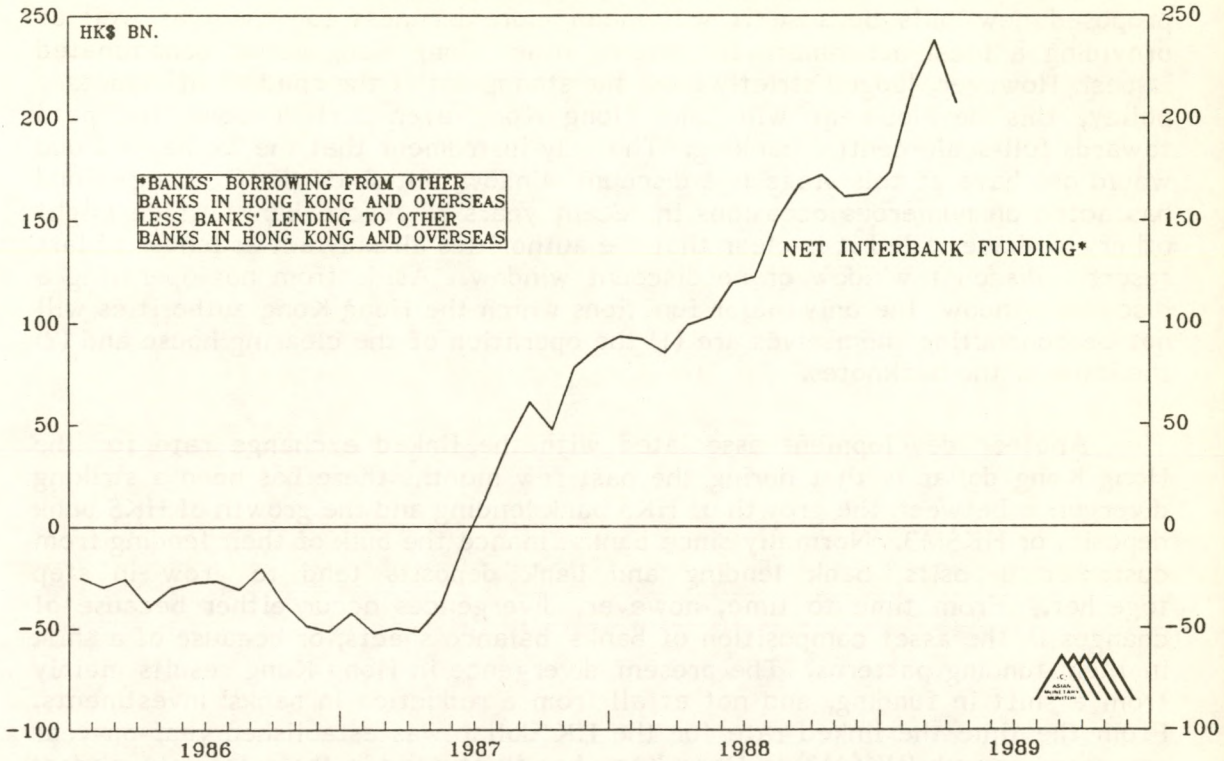


HONG KONG: CHART 6

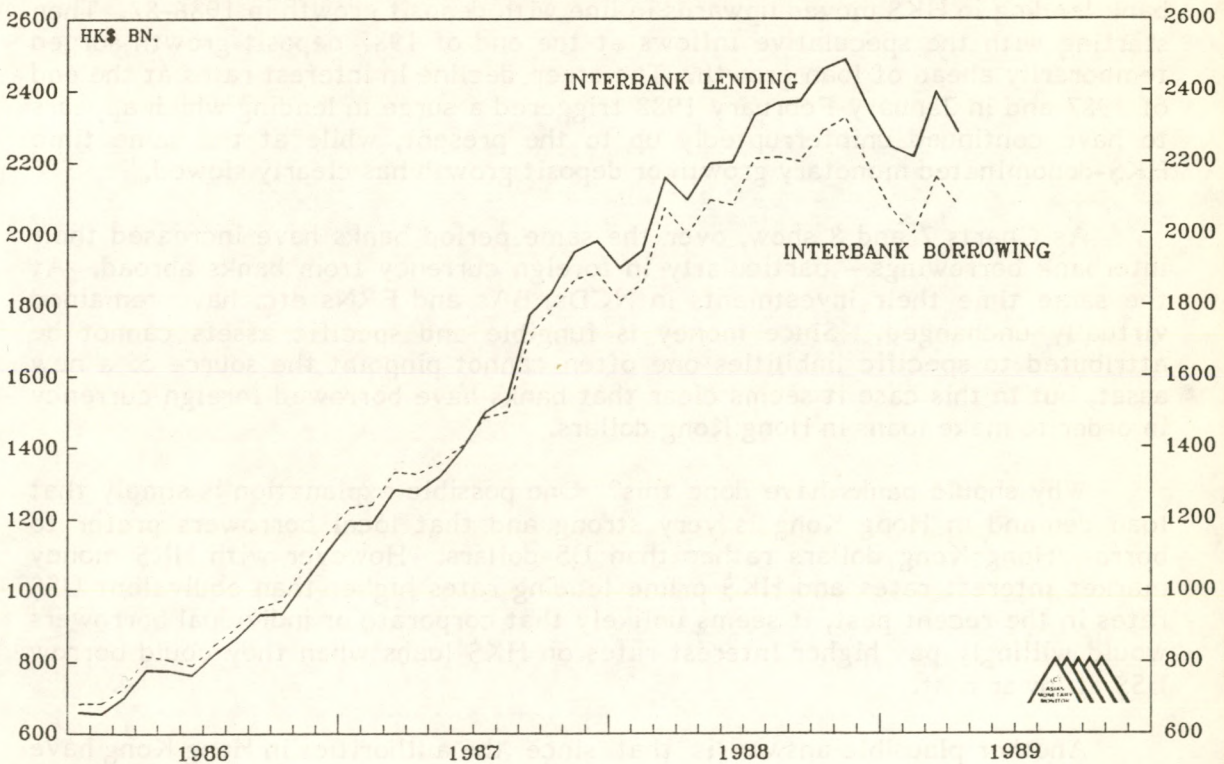
LEVELS OF LOANS AND ADVANCES AND DEPOSITS



HONG KONG: CHART 7 NET INTERBANK FUNDING



HONG KONG: CHART 8 LEVELS OF INTERBANK LENDING AND BORROWING



capital market in Hong Kong. Not surprisingly, capital market participants such as banks, merchant banks and brokers have reacted enthusiastically to the proposed new bills because it will mean more business for them as well as providing a local benchmark for pricing other Hong Kong dollar denominated issues. However, judged strictly from the standpoint of the conduct of monetary policy, this development will take Hong Kong even further down the path towards full-scale central banking. The only instrument that the Exchange Fund would not have at this stage is a discount window, but since the Exchange Fund has acted on numerous occasions in recent years to rescue banks which might otherwise have failed it is clear that the authorities already act as lender of last resort - discount window or no discount window. Aside from not operating a discount window, the only major functions which the Hong Kong authorities will not be conducting themselves are (1) the operation of the clearing house and (2) the issue of the banknotes.

Another development associated with the linked exchange rate for the Hong Kong dollar is that during the past few months there has been a striking divergence between the growth of HK\$ bank lending and the growth of HK\$ bank deposits or HK\$M3. Normally since banks finance the bulk of their lending from customer deposits, bank lending and bank deposits tend to grow in step together. From time to time, however, divergences occur either because of changes in the asset composition of banks' balance sheets, or because of a shift in their funding patterns. The present divergence in Hong Kong results mainly from a shift in funding, and not at all from a reduction in banks' investments. From the time the linked rate for the HK dollar was established year-on-year monetary growth (HK\$M3) in Hong Kong has fluctuated in the relatively modest range of 12% to 26%. Since December 1987 HK\$M3 growth has slowed from the top end of the range to the bottom end of the range. As shown in Charts 5 and 6 bank lending in HK\$ moved upwards in line with deposit growth in 1986-87. Then starting with the speculative inflows at the end of 1987 deposit growth surged temporarily ahead of loan growth. The steep decline in interest rates at the end of 1987 and in January-February 1988 triggered a surge in lending which appears to have continued uninterruptedly up to the present, while at the same time HK\$-denominated monetary growth or deposit growth has clearly slowed.

As Charts 7 and 8 show, over the same period banks have increased their interbank borrowings - particularly in foreign currency from banks abroad. At the same time their investments in NCDs, BAs and FRNs etc. have remained virtually unchanged. Since money is fungible and specific assets cannot be attributed to specific liabilities one often cannot pinpoint the source of a new asset, but in this case it seems clear that banks have borrowed foreign currency in order to make loans in Hong Kong dollars.

Why should banks have done this? One possible explanation is simply that loan demand in Hong Kong is very strong and that local borrowers prefer to borrow Hong Kong dollars rather than US dollars. However with HK\$ money market interest rates and HK\$ prime lending rates higher than equivalent US\$ rates in the recent past, it seems unlikely that corporate or individual borrowers would willingly pay higher interest rates on HK\$ loans when they could borrow US\$ at lower cost.

Another plausible answer is that since the authorities in Hong Kong have

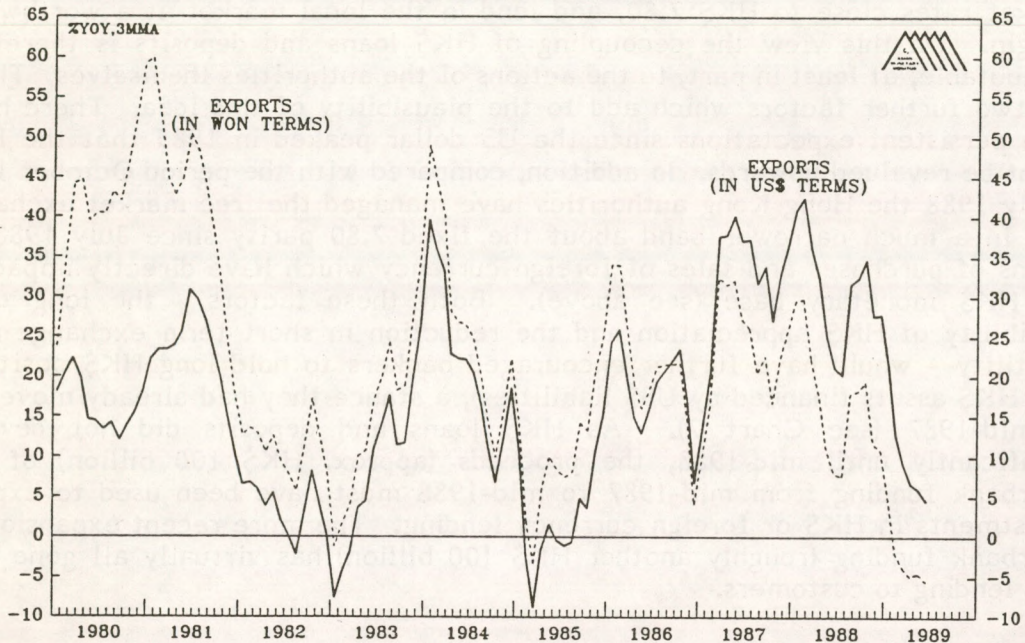
been using the central banking tools they introduced in July 1988 deliberately to keep HK\$ interest rates above their equilibrium rates, they have thereby been providing an incentive for banks to borrow US\$, convert the proceeds to HK\$ at market rates close to HK\$ 7.80, and lend in the local market at a worthwhile margin. On this view the decoupling of HK\$ loans and deposits is therefore attributable, at least in part, to the actions of the authorities themselves. There are two further factors which add to the plausibility of this idea. There have been persistent expectations since the US dollar peaked in 1985 that the HK\$ might be revalued upwards. In addition, compared with the period October 1983 - July 1988 the Hong Kong authorities have managed the free market exchange rate in a much narrower band about the fixed 7.80 parity since July 1988 by means of purchases and sales of foreign currency which have directly impacted the HK\$ monetary base (see above). Both these factors - the long term possibility of HK\$ appreciation and the reduction in short term exchange rate volatility - would have further encouraged bankers to hold long HK\$ positions (i.e. HK\$ assets financed by US\$ liabilities), a stance they had already moved to in mid-1987 (see Chart 7). As HK\$ loans and deposits did not deviate significantly until mid-1988, the proceeds (approx. HK\$ 100 billion) of the interbank funding from mid-1987 to mid-1988 must have been used to expand investments in HK\$ or foreign currency lending. The more recent expansion of interbank funding (roughly another HK\$ 100 billion) has virtually all gone into HK\$ lending to customers.

CONCLUSION.

The run on the Hong Kong branches of the Bank of China and its sister banks in the wake of the Tiananmen massacre has provided another test of the linked rate system for the Hong Kong dollar. Instead of the anxiety about events in China leading to a serious external drain, as some observers expected, the internal cash drain proved to be the more dominant phenomenon. However, the impact of the internal drain was itself partially offset by an injection of funds into the system by the Exchange Fund using the intervention machinery created in July 1988. These operations are to be supplemented later this year by the introduction of Exchange Fund bills, at which time the authorities will possess effective tools for both domestic money market intervention and foreign exchange market intervention. Both sets of operations will have comparable multiplier effects on the broader monetary system, giving the authorities scope for day-to-day discretionary intervention in the classic style of any central bank. With these developments, it will no longer be possible to say that Hong Kong's monetary system is an automatic, non-discretionary system. Regular operations by the authorities in the domestic money market and in the foreign exchange market will fundamentally alter the character of Hong Kong's monetary system. Whether or not these are desirable changes is largely a value judgment, but given the power to intervene in this way, governments very seldom reverse the process by giving them up. In the July-August 1988 issue of AMM we said that "the new arrangements constitute a major step towards the establishment of a central bank in Hong Kong". Since that time Hong Kong has taken a few steps more along the same road.

S. KOREA: THE ADJUSTMENT TO SLOWER GROWTH

THE REPUBLIC OF KOREA GROWTH OF EXPORTS

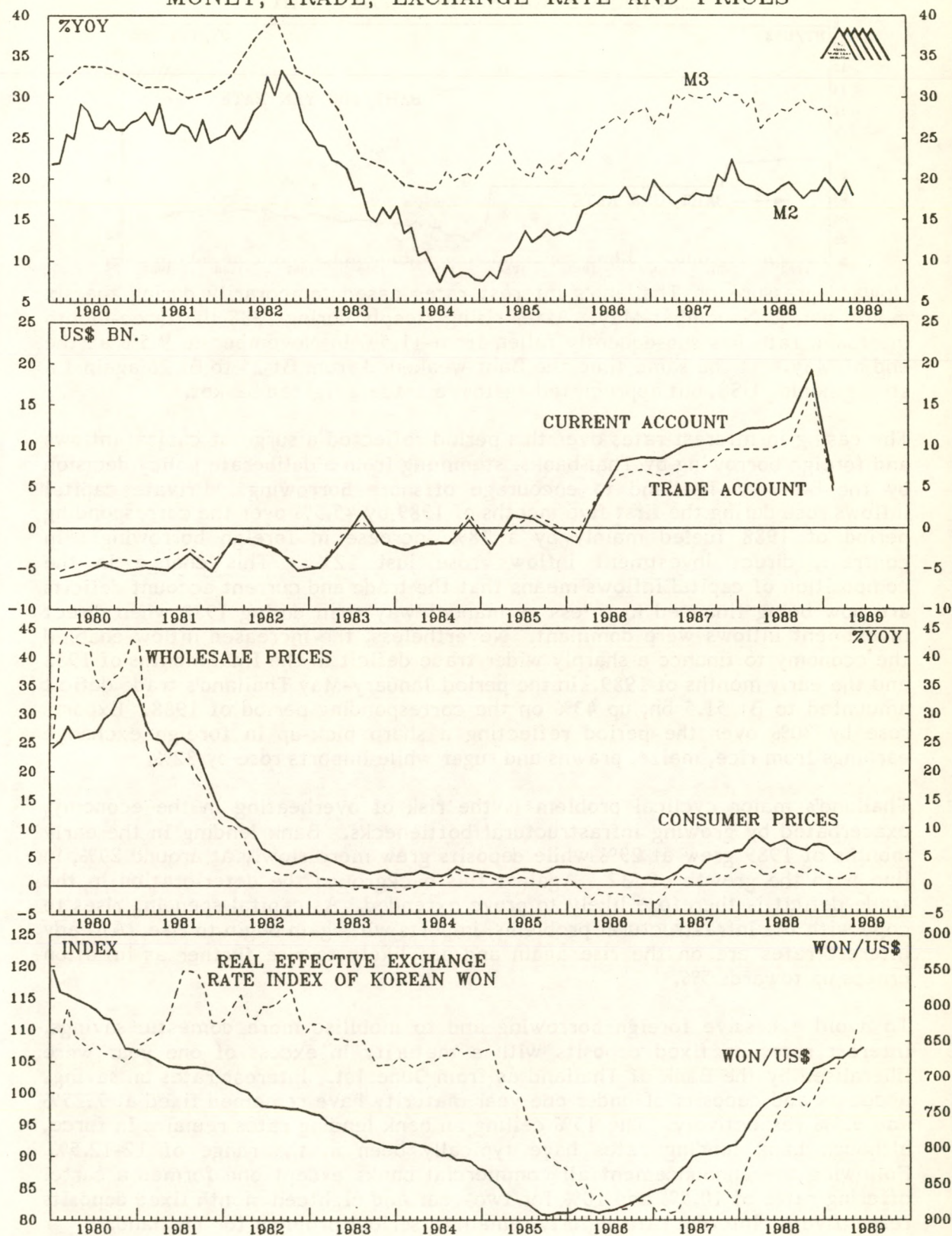


The Korean economy is exhibiting growing imbalances which will necessitate a policy correction. Three years of excessive money growth, with M2 running at an average of 20% and M3 at 30%, have combined with growing labour unrest and slower growth in the country's export markets to produce rising inflation, slowing economic activity and a sharp narrowing in the current account surplus. In May consumer price inflation reached 5.9%; real GNP increased at an annualised rate of 5.7% during the first quarter, compared with 15.7% during the corresponding period of 1988, while the current account surplus during the first five months was just US\$2.1 billion compared with \$4.6 billion in the same period of 1988.

To date the authorities have resisted calls for a wage freeze and further price controls. Instead they have limited their actions to imposing a 10% ceiling on pay increases for civil servants and to exerting moral suasion on consumers to restrain expenditure. But the root cause of Korea's current problems has yet to be addressed. Part of the authorities' plans also include a decision to cease to appreciate the won to regain export competitiveness and boost economic growth. However, it was the failure to allow the won to appreciate fast enough in response to Korea's huge current account surplus which created the current problems in the first place. As a result, the authorities struggled to sterilise the resultant build-up in liquidity. The inevitable economic adjustment is consequently proceeding via higher inflation, rather than via a more rapid appreciation in the nominal exchange rate. The consequence will be lower growth and higher inflation.

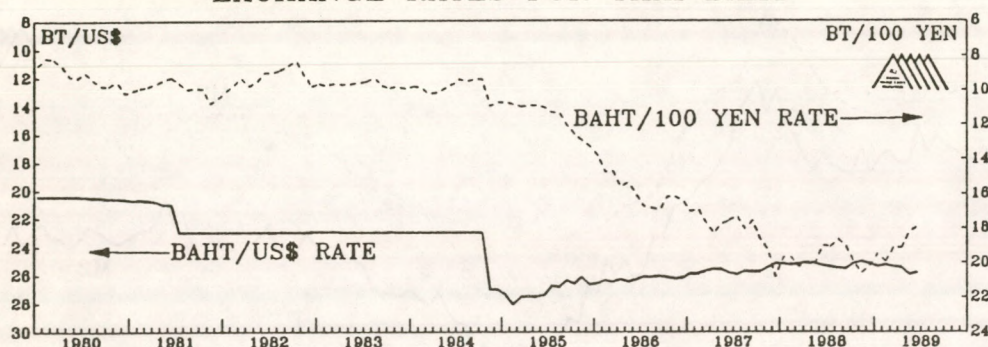
The optimal solution to Korea's current problems would be to combine more rapid appreciation of the currency, with a slower pace of sterilisation, thereby allowing domestic demand to take over as the driving force of economic activity. However, given the political desire to eliminate foreign indebtedness by the early 1990s, this option is set to be rejected.

THE REPUBLIC OF KOREA MONEY, TRADE, EXCHANGE RATE AND PRICES



THAILAND: INTEREST RATES TO START RISING AGAIN

EXCHANGE RATES FOR THAI BAHT



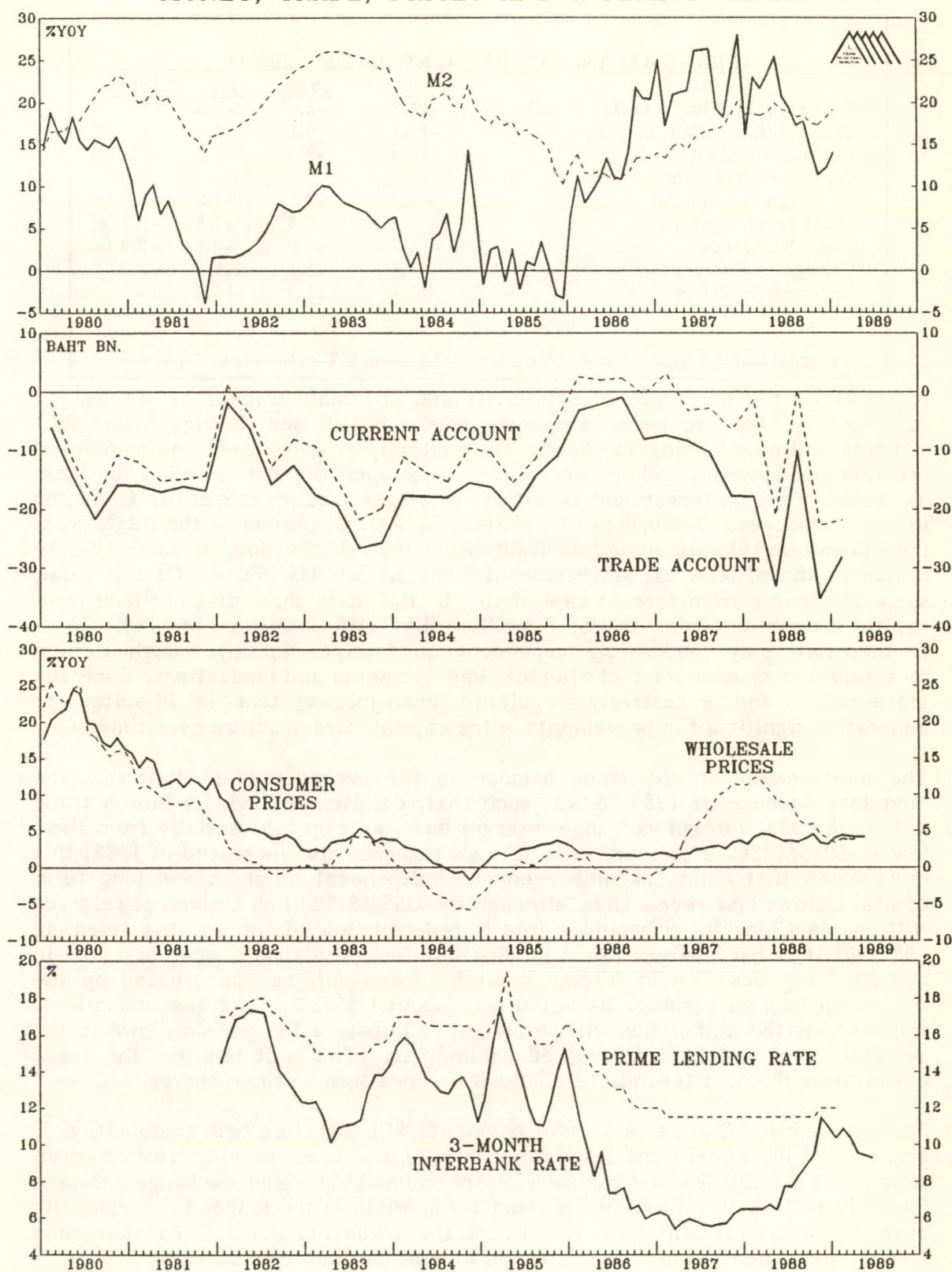
Upward pressure on Thailand's interest rates eased temporarily during the six month period November-May. After rising steeply during 1988 the three-month interbank rate has subsequently fallen from 11.5% in November to 9.5% at the end of May. At the same time the Baht weakened from Bt 25 to Bt 26 against a strengthening US\$, but appreciated against a trade weighted basket.

The easing in interest rates over this period reflected a surge of capital inflows and foreign borrowing by Thai banks, stemming from a deliberate policy decision by the Bank of Thailand to encourage offshore borrowing. Private capital inflows rose during the first five months of 1989 by 45.5% over the corresponding period of 1988 fueled mainly by a 78% increase in foreign borrowing. In contrast, direct investment inflows rose just 12%. This change in the composition of capital inflows means that the trade and current account deficits are now being financed in a less permanent way than during 1988 when direct investment inflows were dominant. Nevertheless, the increased inflow enabled the economy to finance a sharply wider trade deficit in the final months of 1988 and the early months of 1989. In the period January-May Thailand's trade deficit amounted to Bt 51.5 bn, up 43% on the corresponding period of 1988. Exports rose by 30% over the period reflecting a sharp pick-up in foreign exchange earnings from rice, maize, prawns and sugar while imports rose by 32%.

Thailand's major cyclical problem is the risk of overheating in the economy, exacerbated by growing infrastructural bottlenecks. Bank lending in the early months of 1989 grew at 29% while deposits grew more slowly at around 20%, in line with the growth of M2. Against this background the deterioration in the trade deficit is therefore likely to prove extended. As capital spending rises to cope with the infrastructural problems, imports will again begin to rise. Already interest rates are on the rise again and are likely to rise further as inflation creeps up towards 5%.

To avoid excessive foreign borrowing and to mobilise more domestic savings, interest rates on fixed deposits with a maturity in excess of one year were liberalised by the Bank of Thailand as from June 1st. Interest rates on savings accounts and deposits of under one year maturity have remained fixed at 7.25% and 9.5% respectively. The 15% ceiling on bank lending rates remains in force, although bank lending rates have typically been in the range of 12-12.5%. Following the announcement all commercial banks except one formed a cartel offering rates of 10.5% and 10% for two-year and eighteen month fixed deposits respectively. Interest rate rigidity remains a serious problem for Thailand.

THAILAND MONEY, TRADE, PRICES AND INTEREST RATES



PEOPLE'S REPUBLIC OF CHINA: THE IMPACT OF THE PEKING MASSACRE

CHINA'S BALANCE OF PAYMENTS (in US\$ billions).

	1985	1986	1987	1988
Exports minus Imports (fob basis)	-11.8	-8.4	-0.3	-3.1
Trade Balance (IMF basis)	-13.1	-9.1	-1.6	-4.5 (e)
Current Account	-11.4	-7.0	+0.3	-2.5 (e)
Direct, Portfolio and other				
long term capital	+ 4.4	+7.5	+5.8	+8.0 (e)
Short term capital etc.	+ 2.3	-2.5	-1.4	-3.3 (e)
Overall Balance	- 4.7	-2.0	+4.8	+2.2 (e)
Change in Reserves	- 4.6	-1.3	+4.9	+2.2
Level of Reserves	12.7	11.4	16.3	18.5

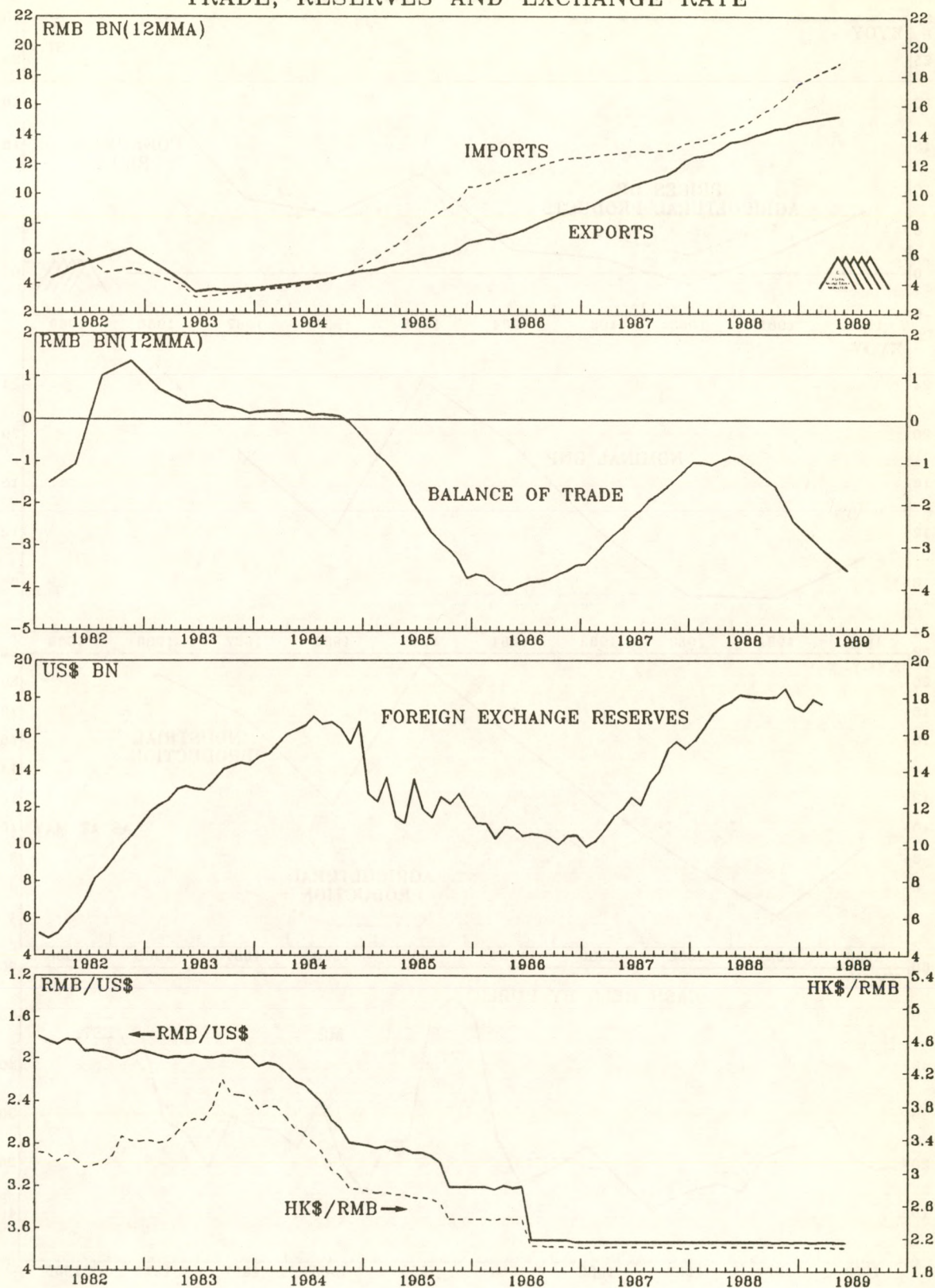
Sources: IMF (IFS), Statistical Yearbook of China, GT estimates.

In terms of the economic effects on China, the main impact of the Peking massacre is likely to be a temporary freeze on all new foreign investment projects and new lending to China. By contrast, existing trade and completed projects in Guangdong and elsewhere seem to be operating normally i.e. "business as usual". Foreign investment is not the only source of investment in China, or indeed the largest. According to the State Statistical Bureau of the PRC, gross investment in 1986 amounted to RMB (Renminbi) 302 billion, or some US\$ 82 billion at the official exchange rate of RMB 3.7 per US dollar. Of this total, some 10% came from foreign capital flows. IMF data show that net long term capital inflows amounted to US\$ 7.5 billion (i.e. RMB 28 Billion) in 1986. China is therefore only moderately dependent on foreign capital, though foreign investment is crucial for technological improvements and innovations, since any state-owned and excessively regulated economic system is ill-suited to generating significant improvements in the capital infrastructure over time.

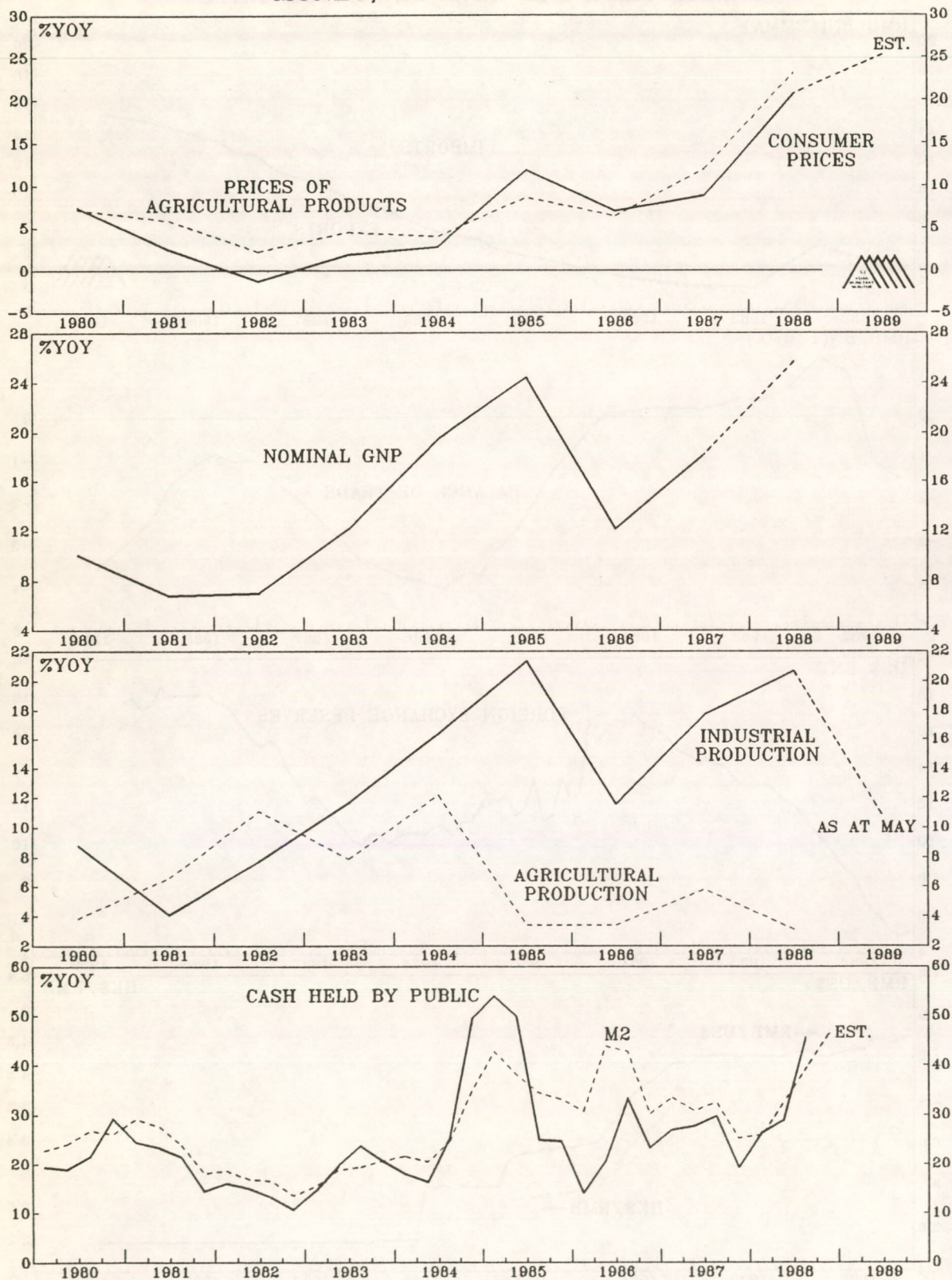
The improvement in the trade balance in the period 1985-87 following the monetary squeeze of 1985-86 was such that, despite the US\$ 3.4 billion trade deficit in 1988, foreign exchange reserves have built up substantially from their low in 1985/1986. However, since China's reserves also increased in 1988, this must mean that China became even more dependent on short and long term capital inflows last year. Thus, although the US\$ 18.5 billion cushion of reserves will enable China to withstand a greatly reduced flow of foreign investment in 1989-90, it is hard to see China holding out for more than a year or two. In addition the reduction in foreign capital inflows will be exacerbated by the decline in foreign earnings from tourism (about US\$ 2.2 billion per annum). It follows that the authorities will be forced to impose a further slowdown in the domestic economy in order to reduce imports. This will improve the trade deficit over the next few quarters, alleviating pressure on the reserves.

The outcome for China's balance of payments will therefore be a combination of less foreign investment and loans (temporarily), and lower earnings from tourism which will be financed by rundown of the country's foreign exchange reserves (possibly to US\$ 10 billion) in the short term, while in the longer term domestic austerity measures will help to correct the trade imbalance. By that time foreign investment should have returned to more normal levels.

CHINA TRADE, RESERVES AND EXCHANGE RATE



CHINA MONEY, OUTPUT AND PRICES







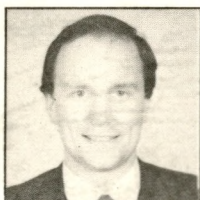
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MACAU: THE CURRENCY SYSTEM OF MACAU

Macau's currency system is an intriguing anomaly. Macau is one of the few places in the world where a foreign currency overshadows the local. Macau's residents have long preferred the Hong Kong dollar to the Macau pataca for holding deposits and even for making many everyday payments.

Macau was settled by the Portuguese in 1557 as a base for trade with China. It is located at the mouth of the Pearl River, approximately 65 kilometers west of Hong Kong and 95 kilometers south of Guangzhou (Canton). The Portuguese constitution defines Macau as a Chinese territory under Portuguese administration. By the Sino-Portuguese Joint Declaration of April 1987, Macau will revert to China on December 20, 1999. The declaration promises that Macau, like Hong Kong, is to become a special administrative region with a high degree of autonomy. Macau is to retain its present social and economic system for fifty years after China takes over. In particular, the existing monetary system is to stay 'basically unchanged', and there are to be no capital or foreign exchange controls (Portugal 1987, Anexo 1, Artigo 12). China's promises about Macau may be more credible than its promises about Hong Kong, because its relations have been better with Macau.

Macau consists of the city of Macau, on a peninsula that contains nearly all of the territory's 450,00 people, plus the islands of Taipa and Coloane. The territory's total area is 18 square kilometers. Its gross domestic product was 7.1 billion patacas (US\$880 million) in 1988. The principal industries are textiles, toy making, gambling, tourism, and construction. Macau's economy has close ties to Hong Kong's, and has enjoyed a similar growth rate in recent years. Unemployment is low.

The main elements of Macau's currency system are the pataca/Hong Kong dollar relationship, the central bank, the government note issue and coinage, and the commercial banks.

The pataca and the Hong Kong dollar - a short history

Macau's local currency, the pataca, dates from 1906. (The pataca is abbreviated Ptc, or, occasionally, MOP, the initials for 'official means of payment' in Portuguese.) Before 1906, the currency was made up of various foreign coins. One of the most popular was the Mexican eight reale silver dollar, known locally as the pataca Mexicana. The silver dollar was the dominant currency unit of East Asia, including Hong Kong and China. The only locally generated elements of the currency were cash deposit certificates, which were

issued by exchange brokers called pangtans. The certificates were quite widely used in Macau (Ma 1987, p. 15). Hong Kong bank notes also circulated in Macau, as they did throughout south China.

To emphasize Macau's political and economic independence from China, in 1901 Macau's government invited the Banco Nacional Ultramarino (BNU) to establish a note-issuing branch. The BNU was a privately owned bank, based in Lisbon, having branches both in Portugal, where it had no note issue, and in Portugal's colonies, where it had a monopoly of note issue (BNU 1981).

The BNU did not begin circulating notes until 1906. The notes had similar designs to those of Hong Kong notes, to promote their acceptance. However, their circulation was tiny for many years (Ma 1987, pp. 15, 17). Most Macanese preferred silver coins or pangtan certificates. The certificates continued to exist, despite the BNU's legal monopoly of note issue, until definitely outlawed in 1944 (Diploma Legislativo 847, Boletim Oficial no. 24, 1944).

The exchange rate between the pataca and the Hong Kong dollar has been one-to-one or close to it throughout the pataca's existence. Until 1935, the two currencies had equivalent silver content. When Hong Kong abandoned the silver standard in 1935, adopting instead a sterling exchange standard, Macau began the policy it has followed subsequently of officially or unofficially linking the pataca to the Hong Kong dollar.

The pataca's official link to the Portuguese escudo under the Bretton Woods system was little more than nominal. Macau kept the pataca even when Portugal made the escudo the currency unit of other colonies in 1954 (BNU 1981). For example, when Hong Kong devalued the dollar in 1949 and 1967, following devaluations in the pound sterling, Macau devalued the pataca to keep the one-to-one exchange rate. Similarly, it revalued the pataca to offset Portugal's devaluation of the escudo in March 1973. The pataca fluctuated within about 1 percent of the Hong Kong dollar, depending on market conditions.

As Portugal's economy weakened under the burden of colonial wars, domestic revolution in April 1974, and a Socialist government's policies, the escudo tumbled, dragging the pataca down with it. The pataca fell to 1.047 per Hong Kong dollar in March 1974 and reached a low of 1.21 on March 10, 1976 (Ma 1987, p. 16). The government's attempt to prop up the pataca in the summer of 1975 was a costly failure (FEER 1976, p. 210). The pataca rallied to 1.06 by May 1976 (FEER 1977, p. 223), and stayed close to that value over the next year.

Portugal devalued the escudo 1 percent in February 1977. In April, Macau decided to let the pataca float against the escudo and to link it officially to the Hong Kong dollar at Ptc 1.075 = HK\$1, with fluctuations of up to 1 percent above or below that rate permitted (Ma 1987, p. 16). Following the fixing to the Hong Kong dollar, the pataca rose 38 percent against the escudo (FEER, May 13, 1977, pp. 45-6).

The government's ultimate goal apparently was to re-establish parity with the Hong Kong dollar, for it suddenly revalued the pataca to Ptc 1.0025 = HK\$1 on December 30, 1978. However, it backed down under strong pressure from bankers, who feared a rush out of patacas into Hong Kong dollars. Leading

businessmen also opposed the revaluation, because it raised the cost of wages and other pataca-denominated expenses. Accordingly, within 48 hours, the government altered the rate to Ptc 1.0425 (Hong Kong Standard, Jan. 1, Jan. 2, 1979). The pataca has been at its present rate of Ptc 1.03 = HK\$1 since May 1983, when it was revalued during the Hong Kong dollar's slide against other currencies (Asian Wall Street Journal, Aug. 2, 1983).

The Hong Kong dollar was a floating currency when the pataca was first linked to it. Since October 1983, the Hong Kong dollar has been linked to the U.S. dollar at the rate of HK\$7.8 = US\$1. The Chinese renminbi has also been linked to the U.S. dollar since August 1986 at an official rate of RMB 3.722 = US\$1, though on the free market, the renminbi is worth only about half as much. Hence Macau and its chief trading partners are in effect within a common currency area based on the U.S. dollar.

The pataca and the Hong Kong dollar today

The Hong Kong dollar has long been a greater portion of Macau's money supply than the pataca, despite the best efforts of the government and the central bank. A law passed in 1953 to outlaw the use of foreign currency (Porteria no. 5:384, Boletim Oficial no. 19, 1953) has had no effect. The Hong Kong dollar's dominance is evident from money supply statistics, such as the following data from the end of 1988, which are representative of the relation to the pataca that has existed for many years:

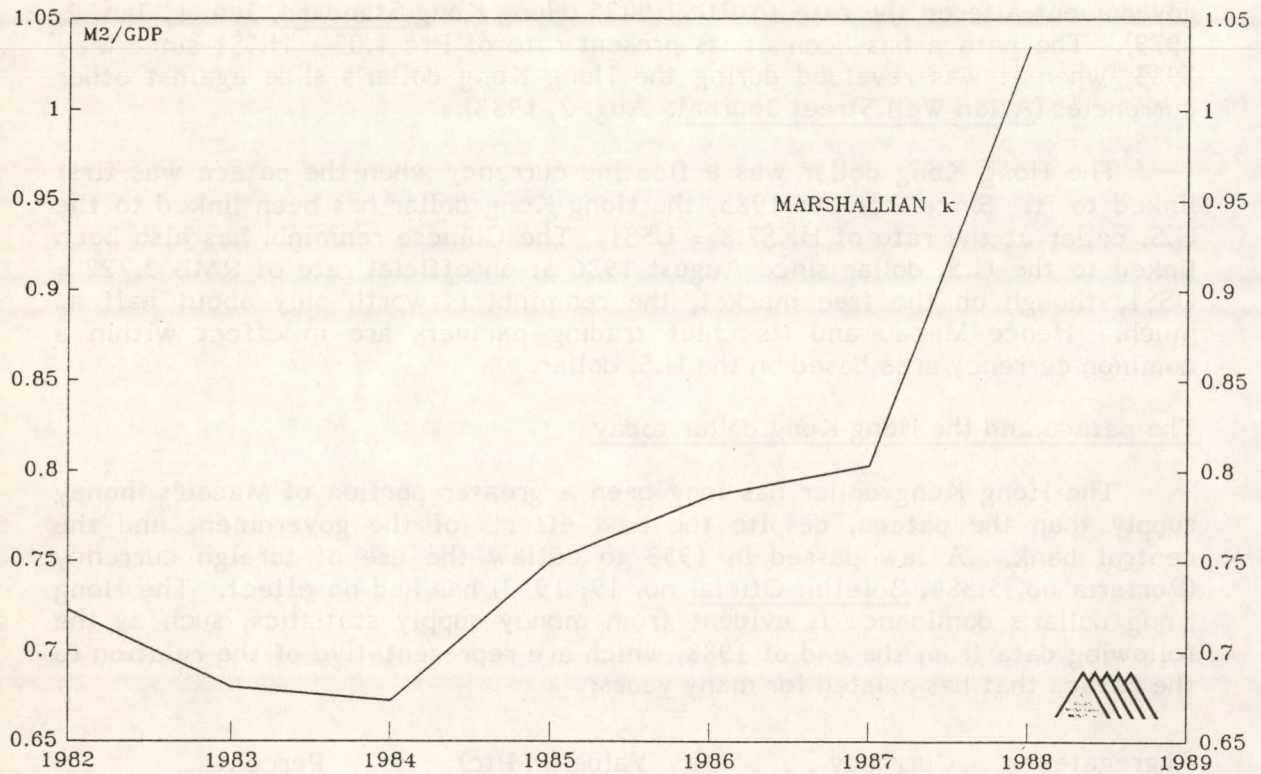
<u>Aggregate</u>	<u>Currency</u>	<u>Value (in Ptc)</u>	<u>Percent</u>
Currency	Ptc	528,700,000	100.0
M1	Ptc	2,405,700,000	38.8
	HK\$	3,013,200,000	48.7
	Others	776,000,000	12.5
M2	Ptc	3,827,600,000	19.1
	HK\$	11,272,700,000	56.3
	Others	4,929,400,000	24.6
Residents' deposits	Ptc	3,315,200,000	17.0
	HK\$	11,298,100,000	57.8
	Others	4,929,900,000	25.2

Source: IEM 1988, pp. 129-130.

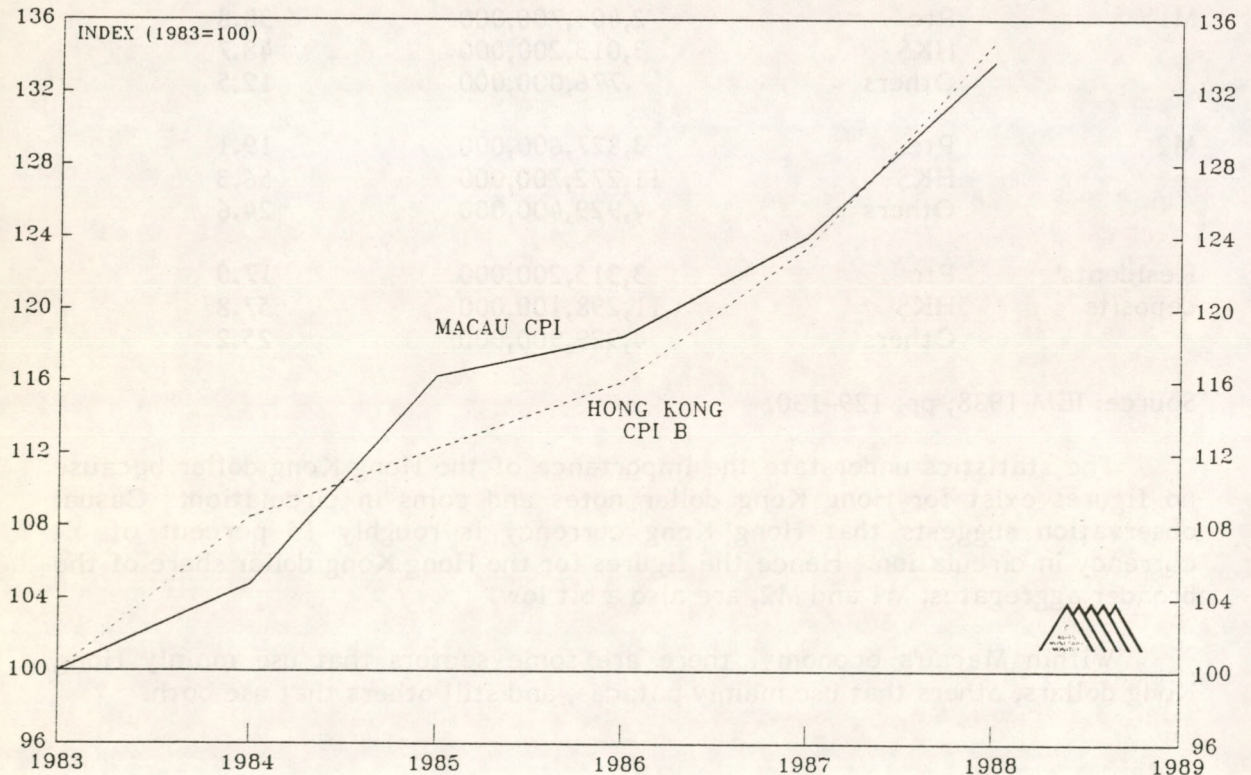
The statistics understate the importance of the Hong Kong dollar because no figures exist for Hong Kong dollar notes and coins in circulation. Casual observation suggests that Hong Kong currency is roughly 15 percent of all currency in circulation. Hence the figures for the Hong Kong dollar share of the broader aggregates, M1 and M2, are also a bit low.

Within Macau's economy, there are some sectors that use mainly Hong Kong dollars, others that use mainly patacas, and still others that use both.

MACAU: CHART 1
MARSHALLIAN k IN MACAU



MACAU: CHART 2
CONSUMER PRICES IN MACAU AND HONG KONG



The most visible sectors where the Hong Kong dollar prevails are gambling and tourism. Gamblers and tourists come mainly from Hong Kong and carry Hong Kong dollars. Macau's merchants willingly accept Hong Kong dollars for payments of the equivalent number of patacas, because it nets them a 3 percent premium. (Hong Kong's merchants, on the other hand, rarely accept patacas or other foreign currencies.) Many merchants keep both currencies on hand, and give change in whichever currency the customers pay them with. A visitor who carries Hong Kong dollars can stay in Macau without ever touching a pataca.

The Hong Kong dollar also dominates the private sector construction and property sectors. Hong Kong residents own some of the choice properties, and many property loans are raised in Hong Kong. The Hong Kong dollar is the customary currency for quoting prices, paying rents, and making sales. It is also frequently used to pay for automobiles, refrigerators, and other expensive consumer goods. However, sellers must quote prices in patacas and accept payment in patacas if buyers wish.

The pataca is the dominant currency for government finance, wage payments, and everyday purchases by the local populace. The government of Macau accepts only patacas for paying taxes and utility bills. (Macau's utilities are all government owned.) All government construction projects are financed in patacas. And local residents usually pay for such items as food and clothing in patacas.

The Hong Kong dollar and the pataca have complementary roles in foreign-trade sectors such as textiles. Macau must import almost everything, and the Hong Kong dollar is a widely accepted currency internationally, whereas the pataca is not. Raw material imports are, therefore, more often paid for in Hong Kong dollars. The same is true of goods exported from Macau. However, wages and other expenses incurred in Macau are generally paid in patacas.

In absolute terms, the pataca money supply has grown throughout the 1980s, but the pataca's share of M1 and especially of M2 has fallen. At the end of 1980, patacas were 40.5 percent of M1 and 26.5 percent of M2 (IEM 1982, p. 108). Compare the 1980 figures with the more recent ones of the table above. The Hong Kong dollar's share of M1 and M2 has also declined. Other currencies, particularly the U.S. dollar, have become increasingly significant. At the end of 1981, other currencies were just 1.1 percent of M1 and 6.1 percent of M2 (IEM 1982, pp. 108, 110). The influx of foreign banks since entry restrictions were eased in 1982 seems to be responsible for the growth in the share of other currencies in the broader monetary aggregates. Macau residents' deposits in other currencies have also grown dramatically, from 6.3 percent of the total in 1981 to 25.2 percent in 1988 (IEM 1982, p. 110; 1988, p. 130). The relative decline in Macau's two leading currencies as a component of broader money-supply measures is similar to the relative decline in the Hong Kong dollar's share of the broader money-supply measures in Hong Kong.

Macau's central bank has taken several steps to promote greater use of patacas. Thanks to agreements it has made with the central banks of China and Portugal, the pataca has become readily exchangeable in those countries since February 1, 1989. Previously, the pataca was only readily exchangeable in Macau and Hong Kong. To encourage banks to hold more liabilities in patacas,

instead of converting them into Hong Kong dollars, the central bank has developed pataca monetary bills and currency swaps. Judging from the growth in banks' use of bills and swaps, the central bank has made the pataca a more attractive currency for temporarily holding excess liquidity than it otherwise would have been.

The central bank introduced monetary bills in February 1987. They are overnight to 6 month securities issued at discount by it according to demand from banks (IEM 1987, p. 83; 1988, p. 88). It began quoting forward rates in foreign currencies in 1985, to reduce exchange-rate risks for banks holding patacas (IEM 1985, p. 10). At the end of 1988, there were Ptc 641.0 million in monetary bills and Ptc 41.83 million in swaps outstanding (IEM 1988, p. 135).

The central bank

Macau's central bank began operations in January 1980. It was originally called the Instituto Emissor de Macau (IEM), or Issuing Institute of Macau. On July 1, 1989, it underwent a reorganization and changed its name to Autoridade Monetaria e Cambial de Macau (AMCM), or Monetary and Foreign Exchange Authority of Macau. At the end of 1988, the central bank had 96 employees, operating expenses of Ptc 132.3 million (including Ptc 16.3 million in personnel expenses), profits of Ptc 100.6 million, total foreign-exchange reserves of Ptc 2.819 billion, and total assets of Ptc 2.586 billion (IEM 1988, pp. 20, 22).

The central bank is an outcome of Portugal's recent policy of granting Macau greater political autonomy. The democratic Portuguese government that took power after the 1974 revolution there gave Macau a new organic law (mini-constitution). Among the law's reforms was to give Macau the power to define its own monetary policy (Macau 1977, Artigo 31.1(n)). The Instituto Emissor de Macau finally opened after lengthy negotiations with the Banco Nacional Ultramarino, which did not want to give up its note issue and its role as government banker without adequate compensation. The BNU still issues notes and is the depository for government funds, but since the central bank was founded, it has acted in both capacities as the central bank's agent.

The central bank's functions are to maintain the value of the pataca, to supervise banking in Macau, and to act as the government banker. Before July 1989, it also issued notes and coins, but the government now exercises the issue powers directly. The other major change of the July reorganization was to increase the government's direct control over the central bank by making the Secretary of Economic Affairs the chairman of its Consultative Council. The council has representatives of banks and the government. A three-member Board of Directors oversees the central bank more closely. The board's members all sit on the Consultative Council and all are appointed by the Secretary of Economic Affairs.

To ensure the pataca's convertibility, the central bank is required by law to maintain certain foreign-exchange reserves. It must keep a specific set of readily disposable foreign assets equal to at least 70 percent of its demand deposits. (Banks and government bodies hold demand deposits with the central bank.) At least 30 percent of its total assets must mature within three months. The central bank's foreign asset holdings have generally far exceeded the

requirements. At the end of 1988, foreign assets maturing within three months were equal to 146.6 percent of demand deposits. A broader, non-statutory measure that includes slowly maturing foreign assets on the asset side and monetary bill on the liability side was equal to 117.6 percent (IEM 1988, pp. 18-19).

The central bank's overriding monetary policy objective is to maintain the exchange rate between the pataca and the Hong Kong dollar within narrow limits. The central bank stands ready to buy Hong Kong dollars at 1.029 patacas and to sell them at 1.031 patacas. Until 1987, the buying rate was 1.028 patacas and the selling rate was 1.032 patacas, but the central bank narrowed the spread to encourage pataca holdings. It also abolished the formality that sellers of patacas get its permission before being able to get foreign currency (IEM 1987, p. 84).

The central bank also quotes rates against the U.S. dollar and the most important European and East Asian currencies. Unlike its Hong Kong dollar rates, they fluctuate from day to day. The foreign currency rates are available only to banks. Corporations and the public that want to exchange foreign currency must go through the banks, which charge slightly wider spreads than the central bank to cover their handling costs. For example, the day I visited the BNU, its buying rate was Ptc 1.0285 for Hong Kong dollar notes and Ptc 1.029 for checks, while its selling rate for both was Ptc 1.0315.

The central bank also has a foreign exchange fund called the CCRD. (The initials stand for Central Reserve Fund for Currency in Portuguese.) Exporters who request certificates of origin from Macau's government are required to exchange half of their foreign-exchange sales revenue for patacas. In 1988, sales to the CCRD were Ptc 4.851 billion (IEM 1988, p. 136). Most of Macau's exports pass through Hong Kong. Without the certificates of origin, they would be treated as Hong Kong products, which are subject to more trade barriers than are Macanese products. Exporters sell directly to the CCRD at the central bank's foreign-exchange rates without incurring additional commission charges from their banks. Macau has no other foreign exchange regulations.

The government note issue

For many years, note issue in Macau was a function of the private sector. The Banco Nacional Ultramarino was the main issuing bank. (After the note issues of the exchange brokers, or pangtans, were outlawed in 1944, it had a monopoly.) The BNU had to keep reserves equal to at least one-third of its note issue (Macau 1958, pp. 153-7). It held the reserves mainly in Portuguese escudos. To make change for amounts less than one pataca, Macau's people used foreign coins or, during and after World War II, government-issued small-denomination emergency notes called cédulas. The government began retiring the cédulas when it issued the first local coins in 1952 (Ma 1987, p. 18).

When the central bank was established in 1980, it assumed control of note and currency issue. Both the central bank and the government keep their deposits inside the banking system with the BNU.

Note issuance works as follows. For every Ptc 103 that the BNU issues, it

purchases certificates of indebtedness by depositing HK\$100 in a non-interest-bearing account that is 'outside' the banking system. If other banks wish to acquire bank notes from the BNU, they pay it in patacas. The BNU then sells the patacas to the central bank for Hong Kong dollars at the special rate, available only for note-issue transactions, of Ptc 103 = HK\$1, and with the Hong Kong dollars, purchases certificates of indebtedness. The process is reversed when pataca bank note circulation falls.

Since July 1, 1989, the BNU has been the government's agent for note issue rather than the central bank's agent. The man in the street has not noticed any change as a result of either of the changes in the note issue in the last ten years. Macau bank notes have always borne the BNU's imprint, and coins have always borne the government's mark.

In the summer of 1989, there was some discussion in Macau, as in Hong Kong, about whether the Bank of China should be allowed to issue pataca notes alongside the BNU. Macau's government rejected the idea on the grounds that Bank of China issue would infringe on the distinct economic system that the Sino-Portuguese Joint Declaration guarantees to Macau. However, when the contract that the government made with the BNU expires in October 1995, the government may reconsider the note issue question. Although government officials have been careful not to say so, it appears that the recent central bank reorganization was made on political rather than economic or administrative grounds. The future of Macau's currency system will be decided by political considerations. The reorganization makes the currency system, and particularly the note issue, explicitly a political matter by bringing it under direct government control.

Commercial banks

At the end of 1988 there were 23 monetary institutions in Macau: 21 banks, the government-run postal savings bank, and a finance company jointly owned by three banks. Of the banks, seven are local, five Portuguese, two Hong Kong, and one Chinese (IEM 1988, p. 137). The total assets of the monetary sector at the end of 1988 were MOP 47.5 billion (*ibid.*, p. 123). There were 94 bank branches (*ibid.*, p. 132).

The Bank of China's local subsidiary (before 1987, called Nam Tung Bank) is by far the largest bank in Macau, with slightly over half the system's assets. The Bank of China also owns 50 percent of the Tai Fung Bank. The Banco Nacional Ultramarino has one-quarter of the system's assets, and Banco Totta y Acores, another Portuguese concern, about one-sixth.

Until 1971, the BNU was the only commercial bank in Macau. There were also exchange brokers who accepted deposits and lent money on a small scale, but their combined assets were estimated to be no more than two-thirds those of the BNU (Macau 1955, pp. 141-5). Over the next ten years, some exchange brokers received banking licenses. Certain banks from Hong Kong, Portugal, and Brazil also received licenses in recognition of the close economic, political, or cultural links between their countries and Macau. In general, though, foreign banks were kept out of Macau until 1983, when the government opened up the banking system as part of a financial liberalisation that began the previous year

and has continued to the present (IEM 1982, pp. 13, 83; 1983, p. 80). The liberalisation aimed to attract more investment to Macau, which it has done. It has been less successful in its other aim of creating active interbank lending and foreign-exchange markets.

Macau grants three types of banking licenses: commercial, offshore, and investment (Decreto-Lei 35/82/M). Commercial licenses are for banks that offer a full range of services in Macau. They require a minimum capital of Ptc 30 million. Offshore licenses, which have been granted since 1987, are for banks that use Macau only as a booking center for loans. Offshore license holders are exempt from local capital requirements and do not have to pay income taxes; they pay only a license fee and an annual tax. At the end of 1988, there were two offshore banks, both Portuguese (IEM 1988, p. 137). Investment licenses carry powers in between those of the other licenses. The minimum capital is Ptc 50 million. So far, there have been no applications for investment banking licenses.

Banks are required to keep noninterest-bearing reserve deposits at the central bank equal to at least 2 percent of total liabilities. Until 1987, pataca reserve requirements varied from 4 percent to 12 percent, depending on liability maturities, and there were no reserve requirements on foreign currencies. The present regulations apply equally to foreign currency and patacas. The reserve deposits are kept entirely in patacas.

The increasing volume of checks and the growing number of banks made a clearinghouse necessary, and one was established in July 1983 (IEM 1986, p. 91). The clearinghouse handles checks in both patacas and Hong Kong dollars. The BNU is the clearing agent for patacas, and the Bank of China for Hong Kong dollars. Other banks keep non-interest-bearing clearing balances with them. In 1988, the clearinghouse's turnover was 996,530 checks, for a total of Ptc 30.5 billion. Continuing a pattern that has existed from the clearinghouse's beginning, nearly two-thirds of the checks were in patacas, but they accounted for little more than a quarter of the total value of transactions (IEM, p. 139).

The banks have a trade association, the Associao de Bancos de Macau. Unlike the similar body in Hong Kong, the Hong Kong Association of Banks, it is not a quasi-official body with compulsory membership. However, it has been equally successful in fixing common deposit rates for its members, perhaps because the Bank of China and the BNU can wield unusual influence.

Deposit and loan interest rates in Macau tend to follow those in Hong Kong closely. (Hong Kong interest rates, in turn, usually follow U.S. rates.) As in Hong Kong, there is no tax on deposit interest.

The recent history of Macau's banks has not been entirely placid. A number of banks have experienced runs. Probably the most serious occurred in March 1983 against Banco Luso International, and in September 1985 on the Wing Hang Bank, a branch of a Hong Kong bank. Both were falsely rumored to have been in trouble. Nam Tung Bank extended credit to both to tide them over (FEER 1984, p. 209; South China Morning Post, Sept. 17, 1985).

The central bank has once intervened to take over a bank. The Banco do Pacifico went belly up on September 30, 1983. It was the second largest in Macau in terms of deposits, having Ptc 1.4 billion, mostly offshore. The bank had close ties to Hong Kong's Hang Lung Bank, and when Hang Lung failed, Banco do Pacifico followed suit. The central bank lent Ptc 45 million, and commercial banks Ptc 25 million, to liquidate Banco do Pacifico smoothly (IEM 1983, pp. 9, 16; 1985, p. 10). There is no deposit insurance in Macau, but the Banco do Pacifico incident seems to indicate an unwritten policy that no depositor in Macau will lose his money in a bank failure.

The future of Macau's currency system

In light of the pataca's secondary role in Macau's currency system, one must ask whether there is any good reason for its continued existence. The pataca would probably vanish were it not for its privileged legal status.

There are three common arguments for a national currency. The first is that it allows a country to pursue macroeconomic stabilization policies independently of other countries. That argument is not applicable to Macau, which as a small economy heavily dependent on foreign trade has little independence from the economies of its major trading partners, Hong Kong, China, and the United States.

Another argument for a national currency is that a government monopoly of note issue and of reserve creation benefits the nation by appropriating for its government the seignorage that would otherwise accrue to another government. Macau's central bank made profits of Ptc 100 million in 1988. Of that, Ptc 85 million went to the government; the rest was used for the central bank's reserve funds and a pension fund for employees (IEM 1988, p. 21). One could argue that the existence of the pataca keeps Ptc 100 million in Macau rather than draining into the hands of the Hong Kong government.

An alternative way to avoid 'exporting' the profit of currency issue would be to allow Macau banks to issue Hong Kong dollar-denominated notes, and to remove all reserve requirements against notes and deposits. The profit from note issue would accrue to the banks themselves, but would tend to be whittled down towards zero by competition, thus passing the entire benefit on to consumers, in the form of better or cheaper services. The seignorage going to an external government would then be limited to the difference between the market rate of interest and the interest rate that Macau banks receive on their holdings of Hong Kong dollar reserves. The idea is not so farfetched as it may seem. The government could implement it in 1995, when its contract with the BNU expires, by granting note-issuing powers to the Bank of China and any other bank that wants to issue notes. The most likely outcome, though, is that the present system will continue.

The final argument for a national currency is that to some extent, it can insulate a nation from economic manipulation undertaken by another nation to achieve political ends. Hong Kong over the years has had a more strained relationship with China than Macau has had. It is possible that the Chinese authorities will meddle with the Hong Kong dollar but leave the pataca alone after they take control of the two territories. Although the pataca has always

been more or less linked with the Hong Kong dollar, its existence as an independent currency gives the Macau authorities the option of cutting the pataca loose should the Hong Kong dollar suffer grave difficulties. In the light of recent tensions between China and Hong Kong, Macau will continue to want to have that option.

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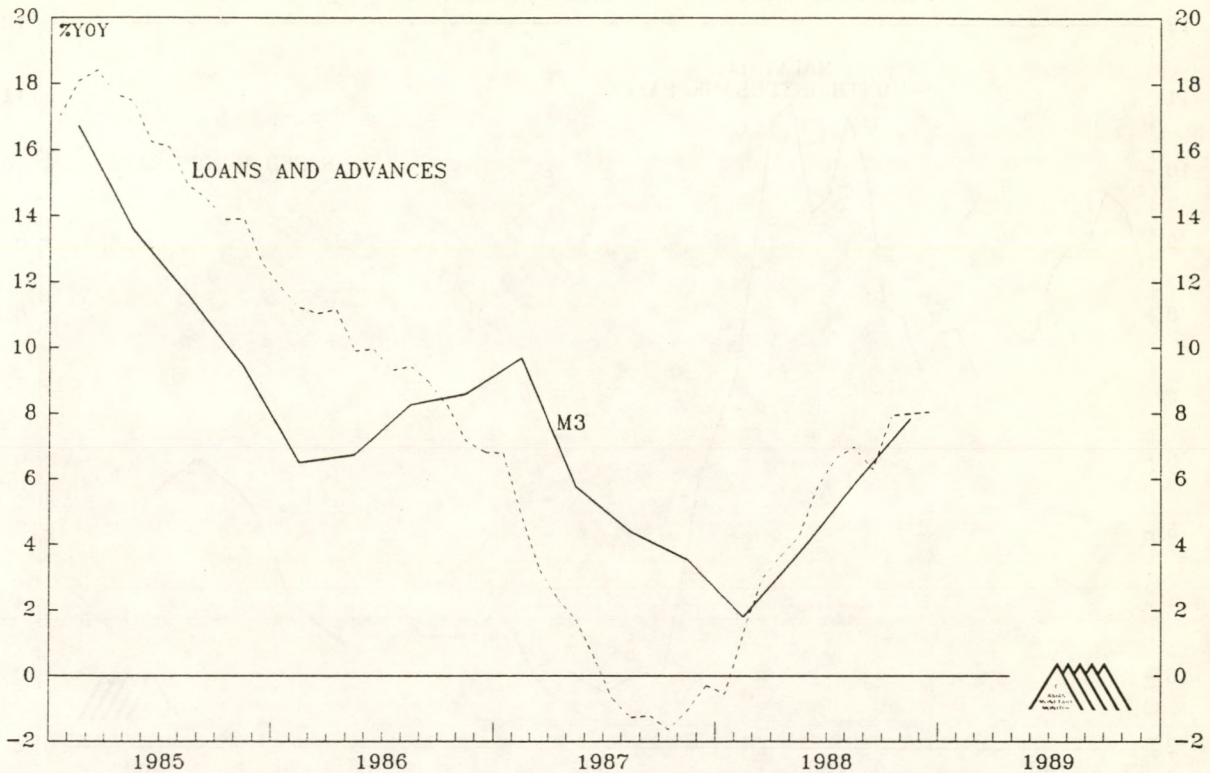
MALAYSIA: AN ABRUPT TIGHTENING OF MONETARY POLICY

There were some unusual aspects to monetary developments in Malaysia in 1988, which featured apparently incompatible movements in money and loan growth, the exchange rate and interest rates. Following the fairly fragile economic recovery in 1987 the year saw the growth momentum of the economy fully established, with GDP recording very strong growth of 8.1% for the full year. As a result loan demand began to recover quite strongly, having bottomed out in late 1987 (see Chart 1). However, the rate of money supply growth remained quite low, well below the growth rate of nominal GDP (see, also, Chart 1). This was all the more surprising given that, on the back of Malaysia's export-led recovery the current account of the balance of payments, although deteriorating somewhat, still remained in healthy surplus for the year (Chart 2).

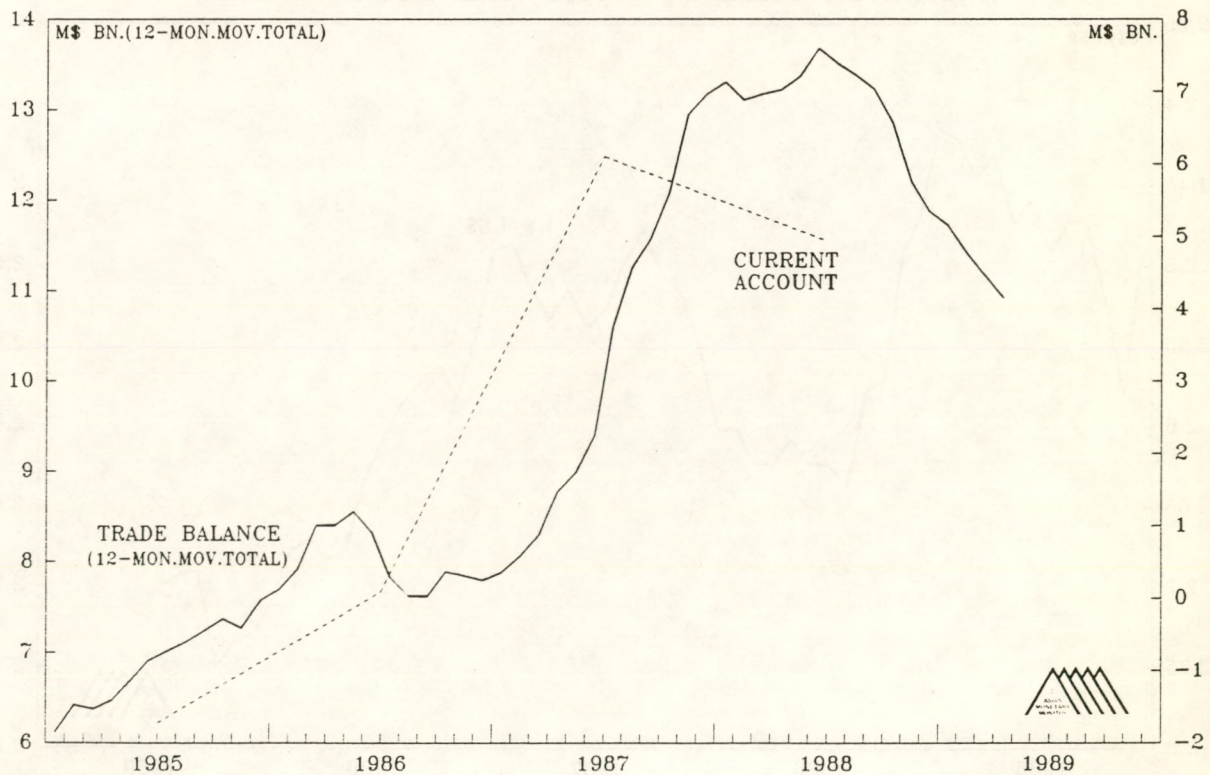
With the growth in loan demand outstripping the growth of deposits it would normally have been expected that interest rates would be under upward pressure. However, as Chart 3 indicates, although rising towards the end of the year, interbank interest rates remained unusually low throughout the year. Perhaps more surprisingly they remained well below US interest rates, even though the Malaysian Ringgit weakened fairly continuously against the US dollar (Chart 4). Particularly given that the Malaysian Ringgit is a closely managed currency it would generally be expected that a tendency to currency weakness would be accompanied by higher interest rates. Alternatively, the low level of Malaysian interest rates should have provided a strong incentive to corporations or other investors to borrow Malaysian dollars and deposit in US dollars, thereby benefiting both from the interest rate differential and the weakness of the Malaysian currency vis-a-vis the US dollar. This type of action, in itself, should have placed upward pressure on Malaysian interest rates.

To understand how apparent inconsistencies between the strength of the economy, the rate of money growth and levels of interest rates and exchange rate were sustained for a whole year, it is instructive to examine the asset counterparts to the growth of the broad money supply and also the counterparts to the growth of the monetary base. This is done in charts 5 and 6. Chart 5 illustrates the three important asset counterparts to the growth in broad money, namely lending by the banking system (both the commercial banks and central bank) to the private sector, lending to the public sector net of the increase in government deposits at the central bank and in the banks (which are not part of the money supply), and the increase in net external assets (ie net lending overseas by the central bank and commercial banks). It is immediately apparent from this chart that weakness in broad money growth throughout 1988 stemmed, in a mechanistic way, from a sharp decline in the contributions to money growth from both net foreign assets and the net lending of the banking system to the public sector. While the recovery in bank lending to the private sector contributed more than 12 percentage points to an increase in broad money growth for the year, the contribution of net foreign assets declined by more than 8 percentage points from the third quarter of 1987 to the end of 1988 and the contribution of net lending to the public sector also declined during the year, by

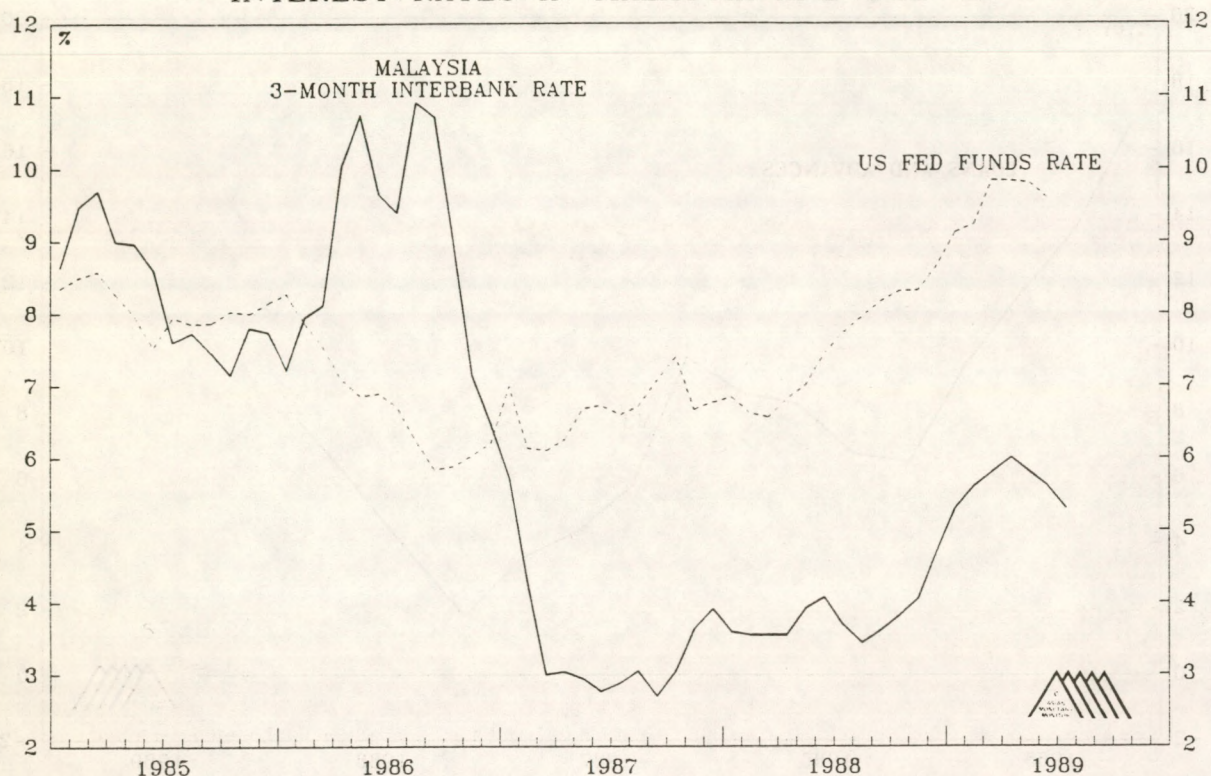
MALAYSIA: CHART 1
MONEY GROWTH AND LOAN GROWTH



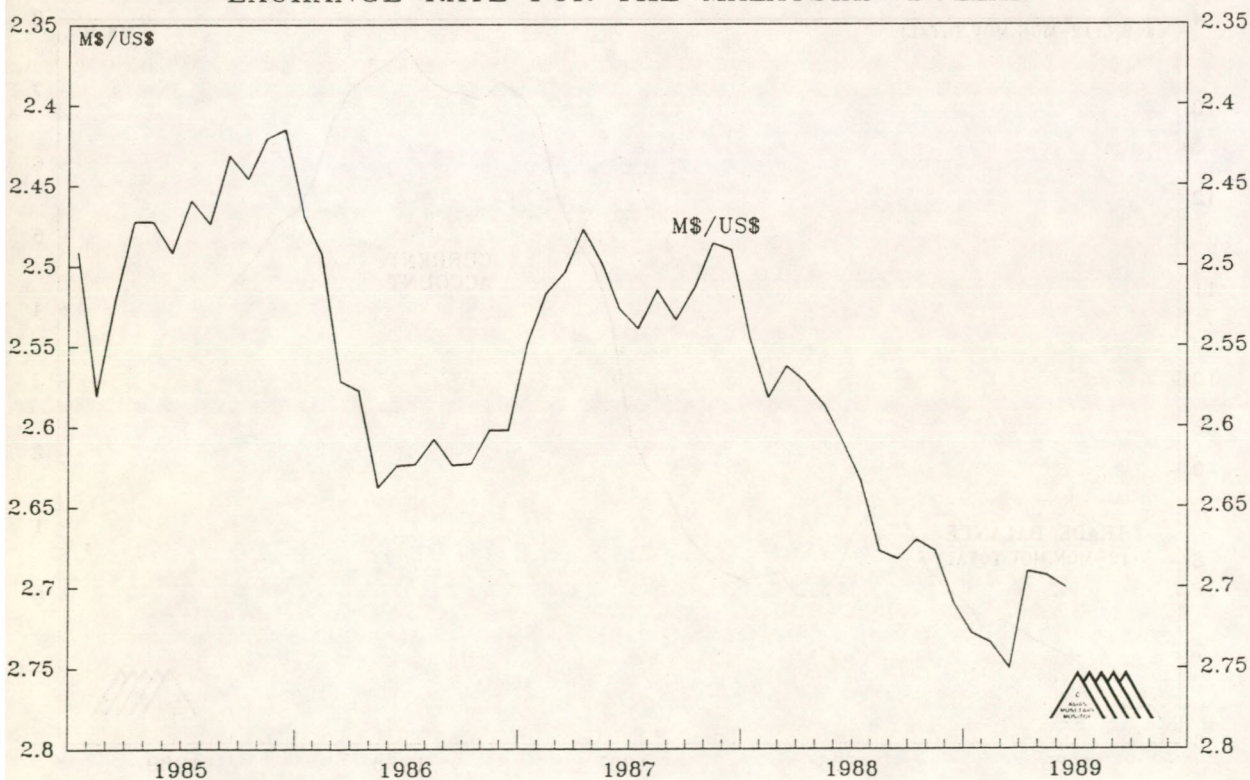
MALAYSIA: CHART 2
TRADE BALANCE AND CURRENT BALANCE



MALAYSIA: CHART 3
INTEREST RATES IN MALAYSIA AND THE US



MALAYSIA: CHART 4
EXCHANGE RATE FOR THE MALAYSIAN DOLLAR



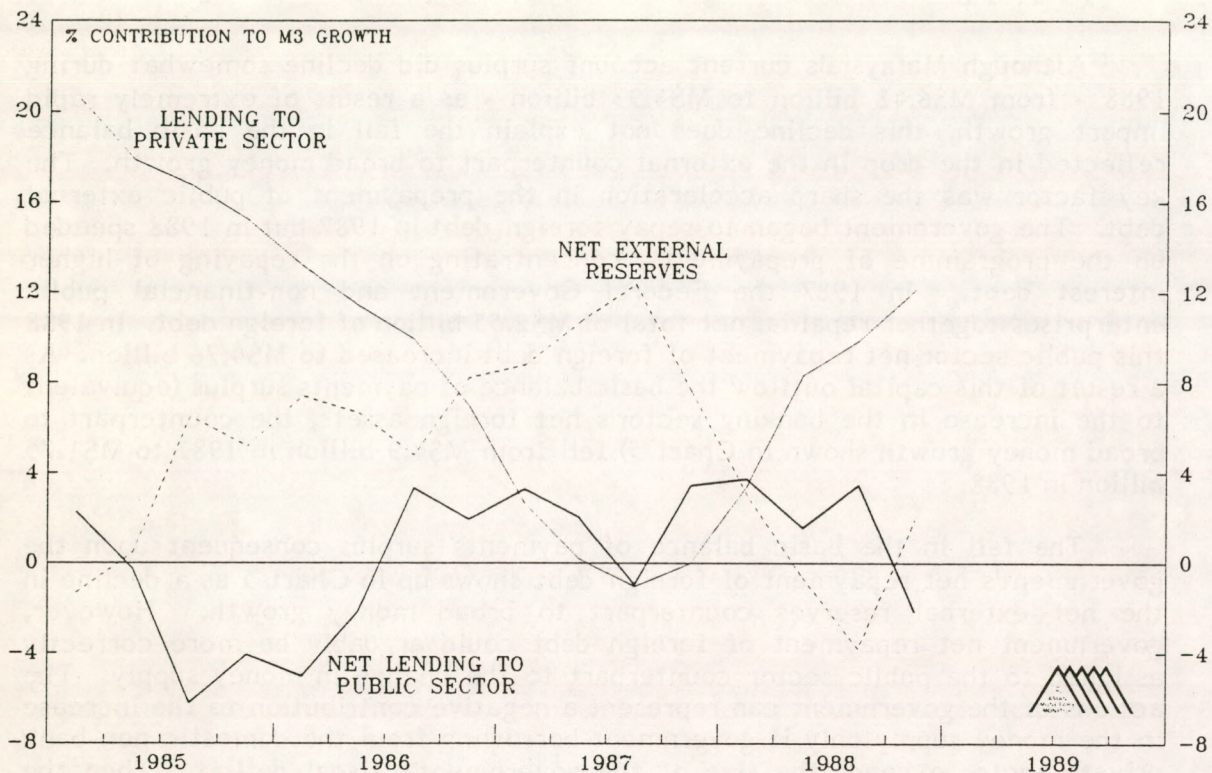
about 5 percentage points. Together the declines in these two counterparts to money supply growth offset the impact of the pick-up in bank lending.

Although Malaysia's current account surplus did decline somewhat during 1988 - from M\$6.48 billion to M\$4.93 billion - as a result of extremely rapid import growth, this decline does not explain the fall in the basic balance reflected in the drop in the external counterpart to broad money growth. The key factor was the sharp acceleration in the prepayment of public external debt. The government began to repay foreign debt in 1987 but in 1988 speeded up the programme of prepayments, concentrating on the repaying of higher interest debt. In 1987 the Federal Government and non-financial public enterprises together repaid a net total of M\$2.55 billion of foreign debt. In 1988 this public sector net repayment of foreign debt increased to M\$4.76 billion. As a result of this capital outflow the basic balance of payments surplus (equivalent to the increase in the banking sector's net foreign assets, the counterpart to broad money growth shown in Chart 5) fell from M\$4.9 billion in 1987 to M\$1.75 billion in 1988.

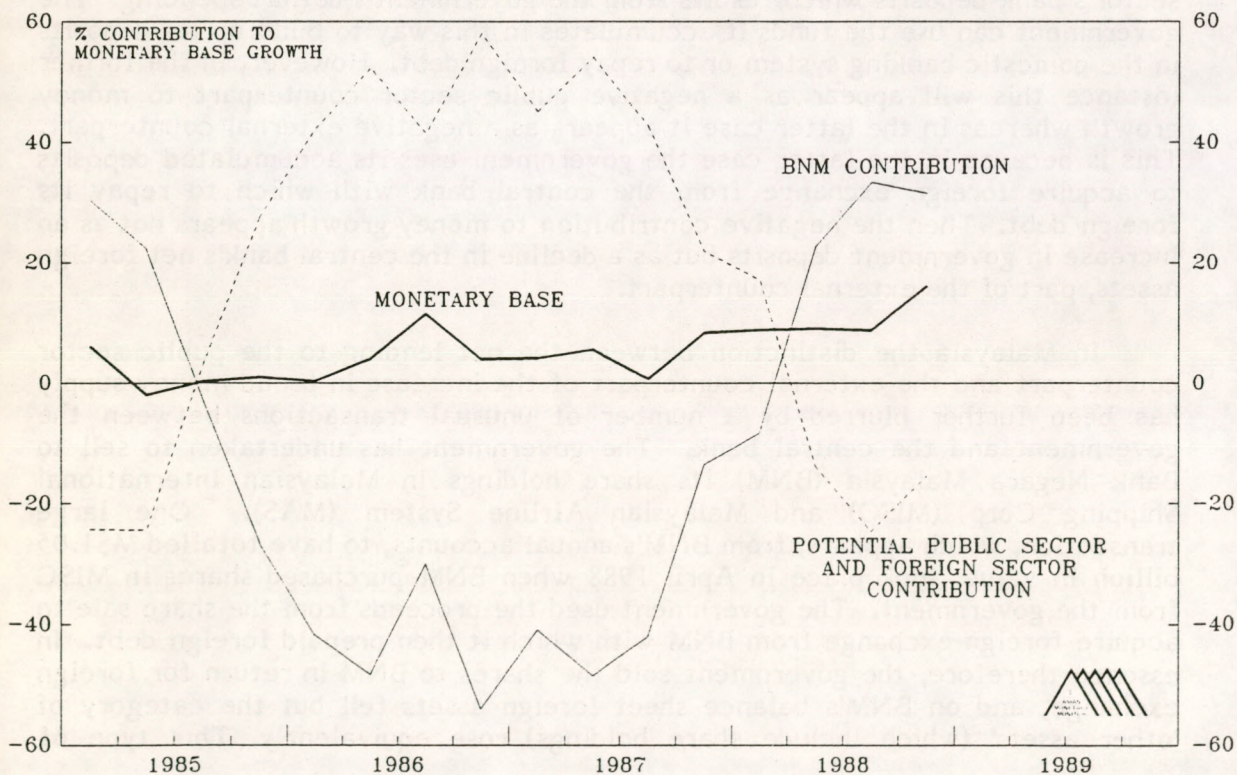
The fall in the basic balance of payments surplus consequent upon the government's net repayment of foreign debt shows up in Chart 5 as a decline in the net external reserves counterpart to broad money growth. However, government net repayment of foreign debt could arguably be more correctly assigned to the public sector counterpart to the change in money supply. The actions of the government can represent a negative contribution to the increase in the money supply only if government borrowing from the domestic non-bank private sector exceeds the size of the government's fiscal deficit. Then the reduction in the domestic private sector's deposits in the banking system arising from purchases of government debt will outweigh the increase in the private sector's bank deposits which results from the government's deficit spending. The government can use the funds it accumulates in this way to build up its deposits in the domestic banking system or to repay foreign debt. However, in the former instance this will appear as a negative public sector counterpart to money growth whereas in the latter case it appears as a negative external counterpart. This is because in the latter case the government uses its accumulated deposits to acquire foreign exchange from the central bank with which to repay its foreign debt. Then the negative contribution to money growth appears not as an increase in government deposits but as a decline in the central bank's net foreign assets, part of the external counterpart.

In Malaysia the distinction between the net lending to the public sector counterpart and the external counterpart of the increase in broad money supply has been further blurred by a number of unusual transactions between the government and the central bank. The government has undertaken to sell to Bank Negara Malaysia (BNM) its share holdings in Malaysian International Shipping Corp (MISC) and Malaysian Airline System (MAS). One large transaction, which appears, from BNM's annual accounts, to have totalled M\$1.05 billion in value, took place in April 1988 when BNM purchased shares in MISC from the government. The government used the proceeds from the share sale to acquire foreign exchange from BNM with which it then prepaid foreign debt. In essence therefore, the government sold the shares to BNM in return for foreign exchange, and on BNM's balance sheet foreign assets fell but the category of 'other assets' (which include share holdings) rose equivalently. This type of

MALAYSIA: CHART 5
DETERMINANTS OF M3 GROWTH



MALAYSIA: CHART 6
DETERMINANTS OF MONETARY BASE GROWTH



transaction only results in a switch in the composition of BNM's assets and has no effect on either the liabilities of BNM (the monetary base) or on the liabilities of the banking system (which include the money supply). However, because it results in a drop in BNM's net holdings of foreign assets it appears as a fall in the external counterpart to the money supply. In Chart 5 an adjustment has been made by adding back an estimate of the reduction in BNM's net foreign reserves owing to this share purchase into the external counterpart of the increase in money supply.

In an accounting sense the public sector and external counterparts to the monetary base differ from the respective asset counterparts to the money supply because the monetary base is a liability of only the central bank whereas the money supply is a liability of the whole banking system. To the extent that government deposits build up in the commercial banks (ie banks' net lending to the government is reduced) this is a negative counterpart to the money supply but not to the monetary base. Similarly, to the extent that net foreign asset holdings of the commercial banks increase this represents a positive asset counterpart to the increase in money supply but not to the increase in the monetary base. The monetary base only increases if the central bank purchases foreign assets.

In practice, in the case of Malaysia, the placement of government deposits from the central bank to the commercial banks is one of the monetary instruments used by BNM to increase the reserve base of the monetary system. If government deposits are shifted from BNM to the commercial banks this transfer of deposits is effected by crediting the banks' reserve accounts at BNM, thereby increasing the monetary base. In a sense, therefore, it could be said that the increase in government deposits in the whole banking system represents the potential contractionary force on the monetary base (because these deposits would normally be placed with the central bank), with the increase in government deposits at the commercial banks seen more as the result of the central banks' operations to expand domestic liquidity.

In Chart 6 the total build-up of government deposits in the banking system (ie the 'potential' (negative) contribution to money base growth) has been combined with the change in BNM's foreign reserves (the external counterpart to money base growth) to give a total potential contribution to money base growth from these two sources. (The external and public sector counterparts have been combined because of the conceptual difficulty of differentiating them in the light of the government's foreign debt repayments.) The residual contribution to money base growth can then be defined as being attributable to the monetary operations of the BNM to withdraw or add reserves, either through sales or purchases of government bonds or other domestic paper, or through placement of government deposits with the commercial banks.

It can be seen from Chart 6 that the 'potential' public sector and foreign sector contribution to money base growth became sharply negative in 1988. The contribution of the external sector to monetary base growth - included in Chart 6 - is much more negative than the external counterpart to the increase in the money supply, shown in Chart 5. This is because there was a large increase in commercial banks' net foreign assets ie a monetary capital outflow, of M\$2.49 billion, in 1988. The monetary capital outflow meant that the overall balance of

payments position, or the change in BNM's foreign reserves, fell into deficit for the year ie BNM's net foreign reserves declined. However, an increase in commercial banks' net foreign asset holdings does not represent a negative counterpart to the change in the total money supply, meaning that the external counterpart to the increase in the overall money supply, although falling, still remained positive for 1988 as a whole (see Chart 5).

The most interesting point to emerge from Chart 6 is the extremely expansionary stance adopted by BNM during 1988. Even though the public sector and external sector contributions to money base growth turned sharply negative the growth of the monetary base itself actually rose sharply during the year as a direct result of the monetary operations of the BNM, which injected large quantities of reserves into the banking system throughout the year. As the growth of the monetary base was far outpacing the growth of the money supply (see Chart 1) this suggests that banks were accumulating excess reserves. In itself this explains the ease of bank liquidity and the low levels of interbank rates throughout 1988, which can therefore be attributed to the policy of the BNM.

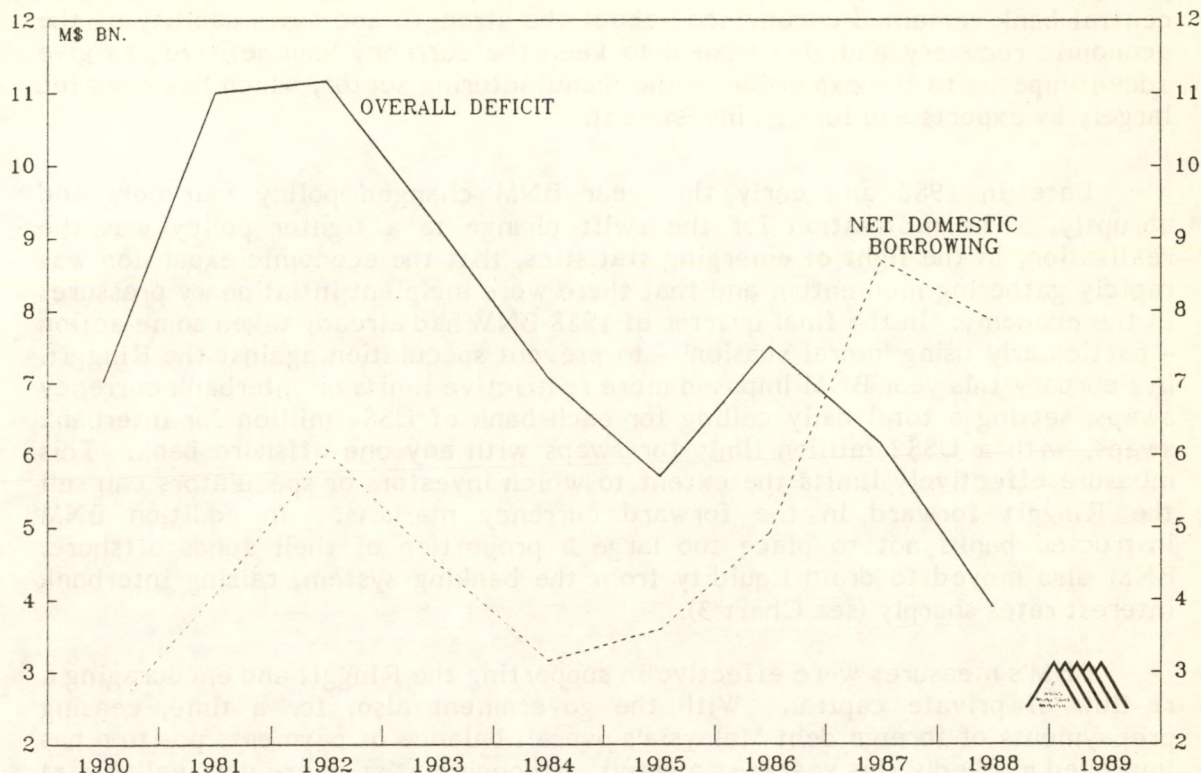
However, in theory, particularly given that the Malaysian Ringgit is a closely managed currency, interest rates should not have remained so far below US rates and deposit growth should not have remained so far below the rate of monetary base growth. Either low interest rates should have encouraged capital outflows from Malaysia, reducing the rate of money base growth and raising the level of interest rates, or the existence of excess reserves in the banking system combined with low interest rates should have encouraged a more rapid expansion in bank lending and deposit growth (or both of these).

In fact both of these consequences did ensue to some extent. Private capital outflows rose as exporters retained export earnings offshore (which they are permitted to do for up to six months) and banks accumulated foreign assets. These private sector capital outflows did contribute negatively to money base growth, as indicated in Chart 6. However Malaysia is not a fully open economy and pure interest rate arbitrage is not legally possible, because borrowing Malaysian Ringgit to purchase foreign currency is not permitted by regulations. To the extent that large private capital outflows did occur the monetary effect was more than offset by the increasingly expansionary stance of BNM, as shown in Chart 6.

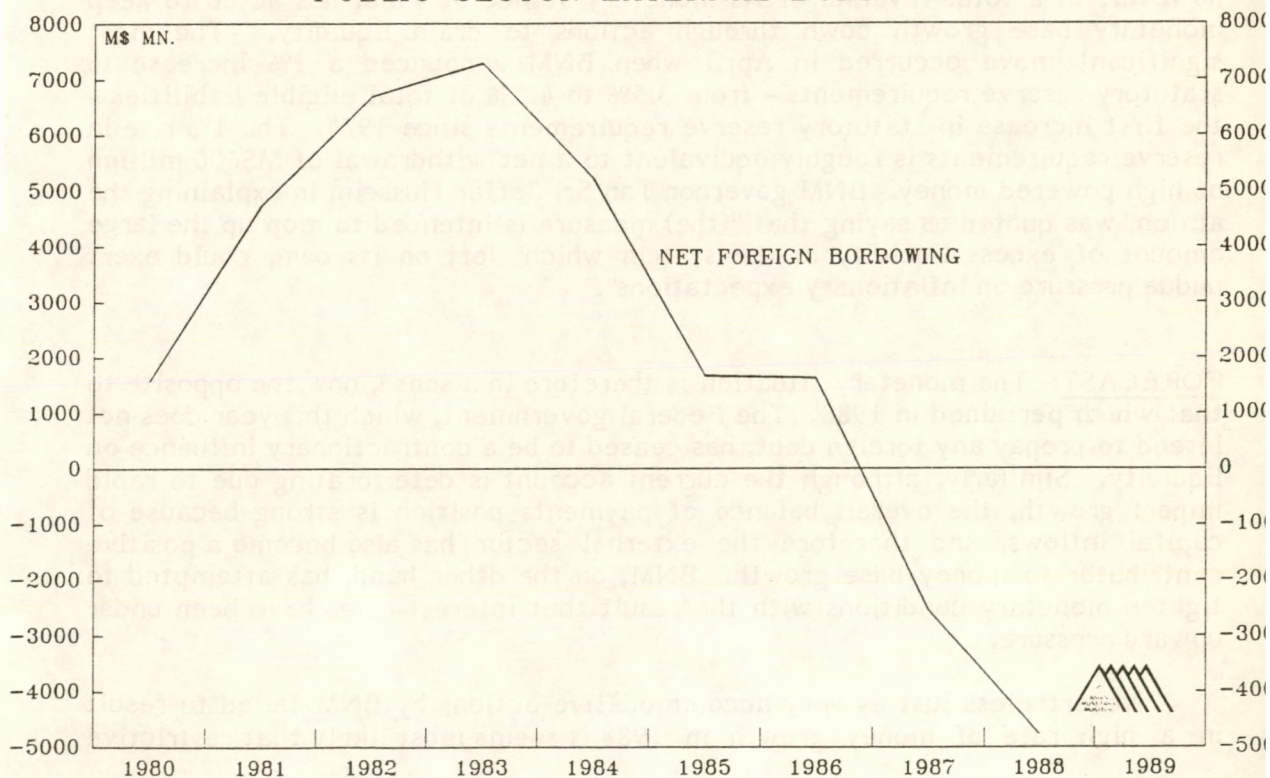
Similarly bank lending growth did pick-up throughout the year, as indicated in Charts 1 and 5. However, rigidities in the Malaysian banking system probably prevented the more rapid acceleration in bank lending that might be predicted by monetary theory. Firstly bank lending and deposit rates and bank credit extension are not fully responsive to market forces because of implicit BNM guidelines on interest rates and explicit guidelines on credit extension (ie priority sector lending). Secondly banks adopted a fairly cautious attitude to lending during 1988 because of concerns over the bad debt problems which accompanied the serious recession of 1985/86. As a result excess reserves were allowed to accumulate in the banking system, driving down interbank rates.

The large private and public sector capital outflows during 1988 did act to place downward pressure on the Malaysian currency, meaning that BNM's policy

MALAYSIA: CHART 7 FEDERAL GOVERNMENT BUDGET DEFICIT AND DOMESTIC BORROWING



MALAYSIA: CHART 8 PUBLIC SECTOR EXTERNAL BORROWING



during the year could be characterised as a low interest rate, weak currency policy. This was very much the intended consequence of BNM's actions as the central bank remained unconvinced about the strength and sustainability of the economic recovery and also wished to keep the currency 'competitive', to give added impetus to the expansion in the manufacturing sector, which has been led largely by exports and foreign investment.

Late in 1988 and early this year BNM changed policy markedly and abruptly. The motivation for the swift change to a tighter policy was the realisation, in the light of emerging statistics, that the economic expansion was rapidly gathering momentum and that there were incipient inflationary pressures in the economy. In the final quarter of 1988 BNM had already taken some action - particularly using 'moral suasion' - to prevent speculation against the Ringgit. In February this year BNM imposed more restrictive limits on interbank currency swaps, setting a total daily ceiling for each bank of US\$4 million for interbank swaps, with a US\$2 million limit for swaps with any one offshore bank. This measure effectively limits the extent to which investors or speculators can sell the Ringgit forward in the forward currency markets. In addition BNM instructed banks not to place too large a proportion of their funds offshore. BNM also moved to drain liquidity from the banking system, raising interbank interest rates sharply (see Chart 3).

BNM's measures were effective in supporting the Ringgit and encouraging a re-flow of private capital. With the government also, for a time, ceasing prepayments of foreign debt Malaysia's overall balance of payments position has improved markedly this year. As a result, although statistics are not available at the time of writing, it appears certain that the external sector has now become a sharply expansionary force in monetary base and money supply growth. BNM, however, in a total reversal of its monetary stance of 1988, has acted to keep monetary base growth down through actions to drain liquidity. The most significant move occurred in April when BNM announced a 1% increase in statutory reserve requirements - from 3.5% to 4.5% of total eligible liabilities - the first increase in statutory reserve requirements since 1974. The 1% rise in reserve requirements is roughly equivalent to a net withdrawal of M\$600 million of high powered money. BNM governor Tan Sri Jaffar Hussein, in explaining the action, was quoted as saying that "(the) measure is intended to mop up the large amount of excess liquidity in the system which, left on its own, could exert undue pressure on inflationary expectations".

FORECAST: The monetary situation is therefore in a sense, now the opposite to that which pertained in 1988. The Federal government, which this year does not intend to prepay any foreign debt, has ceased to be a contractionary influence on liquidity. Similarly, although the current account is deteriorating due to rapid import growth, the overall balance of payments position is strong because of capital inflows, and therefore the external sector has also become a positive contributor to money base growth. BNM, on the other hand, has attempted to tighten monetary conditions with the result that interest rates have been under upward pressure.

Nevertheless just as very accommodative actions by BNM failed to result in a high rate of money growth in 1988 it seems most likely that restrictive

actions will fail to slow money growth in 1989. This is particularly so in that BNM does not appear to be fully committed to actually reducing the rate of money supply growth. This has been most recently evidenced by the fact that BNM has recently refused to allow the commercial banks, whose margins are under pressure from higher interbank rates, to raise base lending rates, leading the banks to threaten to levy service charges on customers. Instead it is likely that as loan demand strengthens, money growth will continue to rise through this year. Money growth is eventually likely to turn down when the overall balance of payments moves back into deficit as a result of the declining current account balance, which now appears to be set in a cyclical deterioration.

SINGAPORE: WEAKNESS IN GROWTH ONLY TEMPORARY

Following very strong growth in 1987 (8.8%) and the first three quarters of 1988, the Singapore economy slowed quite abruptly in the fourth quarter of 1988 and first quarter of 1989. Although the GDP growth rate still reached 11% for the whole year 1988, according to the official numbers (seasonally-adjusted) GDP increased at a rate of only 5.0% in the fourth quarter and 6.3% in the first quarter of this year, on a quarter-on-quarter annualised basis. (The GDP numbers shown in Chart 1 are seasonally adjusted by AMM and show even lower growth rates for the two quarters.)

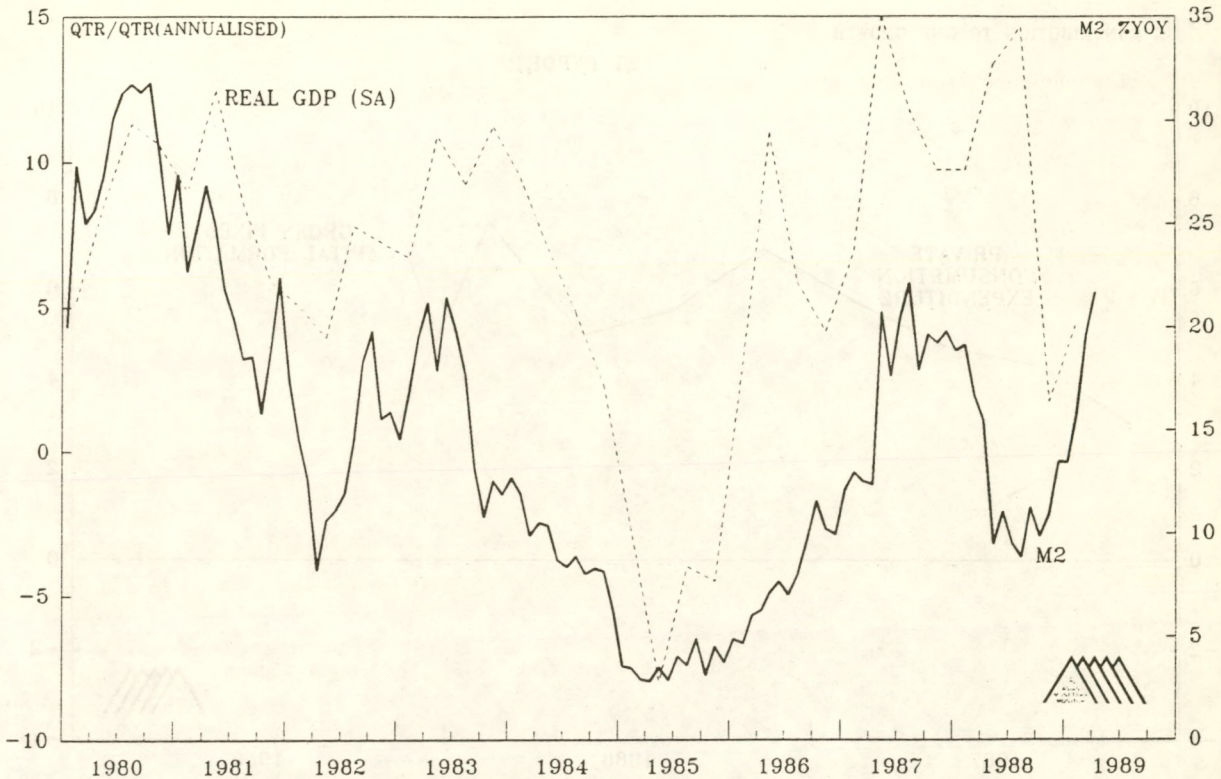
The slowdown in underlying domestic demand was actually more marked than apparent from the national accounts aggregates themselves because both investment and consumption were boosted by 'one-off' factors. In the first quarter total gross fixed capital formation surged by 22.2% from the previous year, but this number was hugely inflated by a large purchase of aircraft by Singapore Airlines. If transport equipment is excluded the year-on-year increase in investment was 7.3% in the first quarter. Evidence from commitments figures suggests that gross foreign investment slackened, Japanese investment showing some weakness (see Chart 2). Additionally, on a net basis, direct investment as measured in the balance of payments would have been further depressed by very high rates of investment by Singapore companies in Johor, Malaysia.

Consumer spending slowed more markedly, the growth in private consumption falling to 6.3%. Even this figure is somewhat misleading because of a huge jump in car sales in advance of an anticipated increase in the car import tax in the March budget (which in the event failed to materialise). Sales volumes of automobiles in the first quarter were up by 105% over the previous year, inflating the overall consumer spending figures.

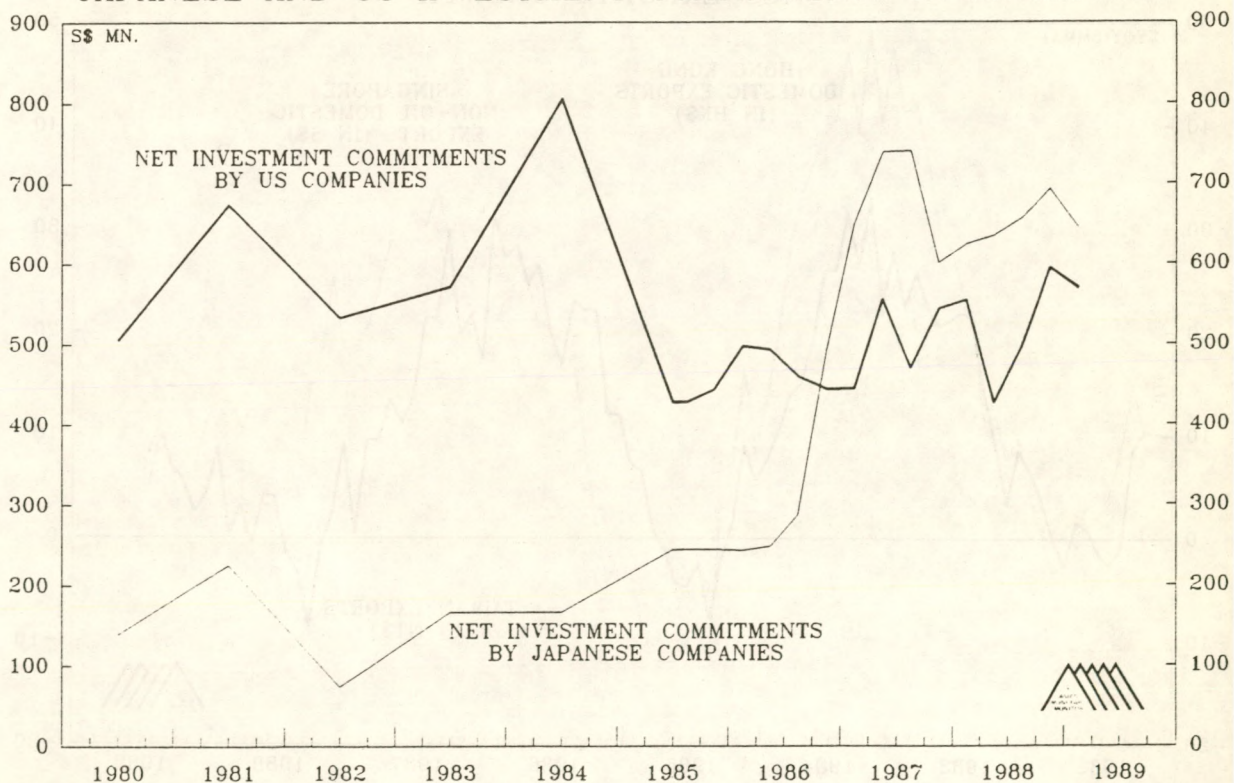
Weaker domestic demand in the first quarter coincided with a sudden drop in exports which resulted from an apparent collapse in certain categories of electrical and electronics product exports in January and February. Exports of computer peripherals, which alone account for 15% of Singapore's domestic exports, had been growing at an annual rate of nearly 60% throughout 1988 but in January and February plunged to show a year-on-year growth rate of only 4.3% for the two month period. As a result Singapore's total domestic export growth rate fell to 10.1% for the first quarter, having been 26.8% for the year 1988 as a whole.

The chart on contributions from each of the broad expenditure components of GDP to the annual growth rate (Chart 3) therefore shows a marked drop in the contribution to overall year-on-year growth from both private consumption and net exports in the first quarter. In terms of contributions a large part of the growth of the economy over the past year (8.4% year-on-year for the first quarter) would then appear to have derived from investment spending. However, as mentioned above, most of the surge in investment was centred in transport equipment. To the extent that this investment merely comprises imported

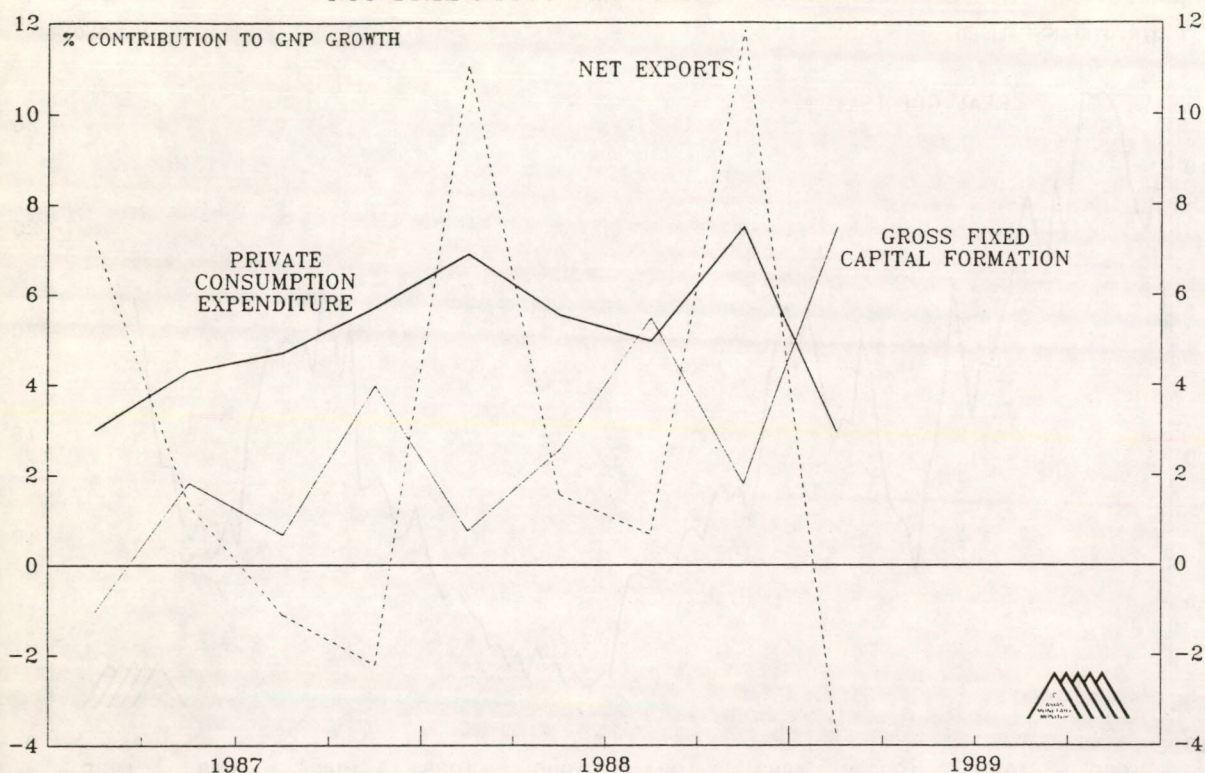
SINGAPORE: CHART 1
M2 GROWTH AND REAL GDP



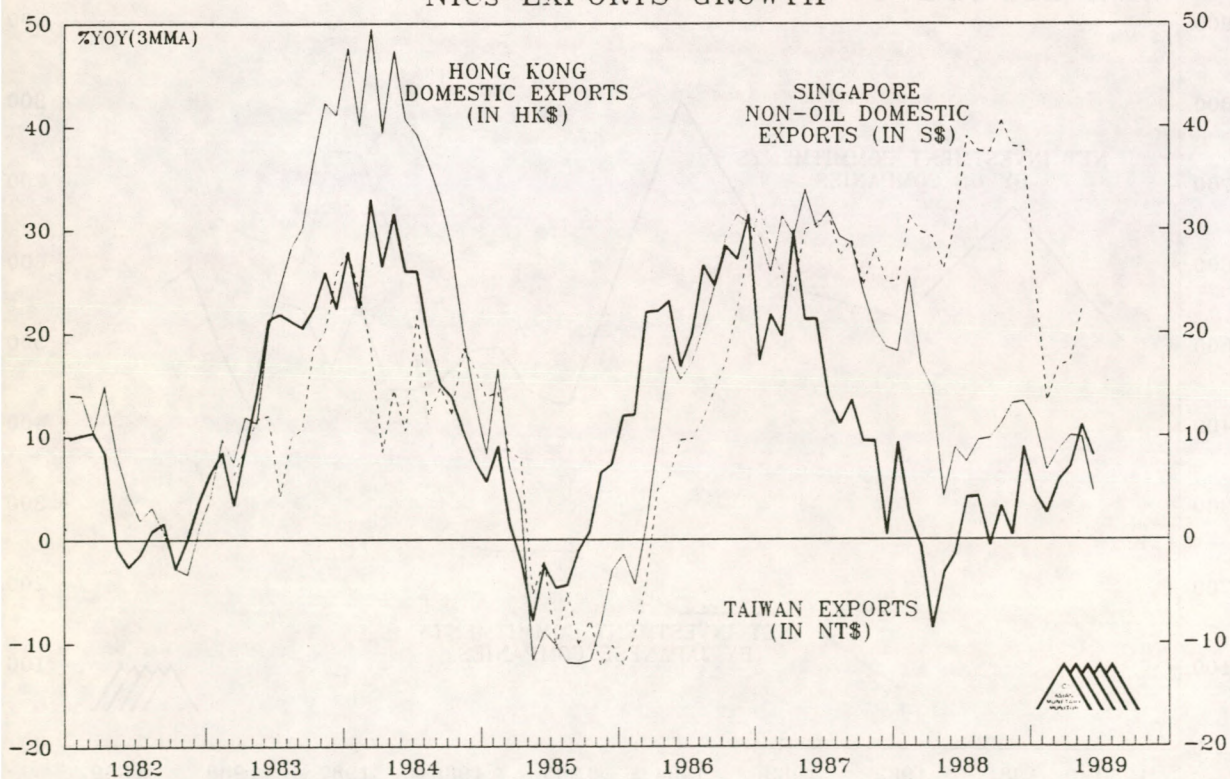
SINGAPORE: CHART 2
JAPANESE AND US INVESTMENT COMMITMENTS IN SINGAPORE



SINGAPORE: CHART 3
CONTRIBUTION TO REAL GROWTH



SINGAPORE: CHART 4
NICs EXPORTS GROWTH



aircraft it does not, in the very first instance, really add to GDP. In some sense, therefore, the contribution of capital formation to growth is exaggerated in Chart 3, and the contribution of net exports equivalently understated.

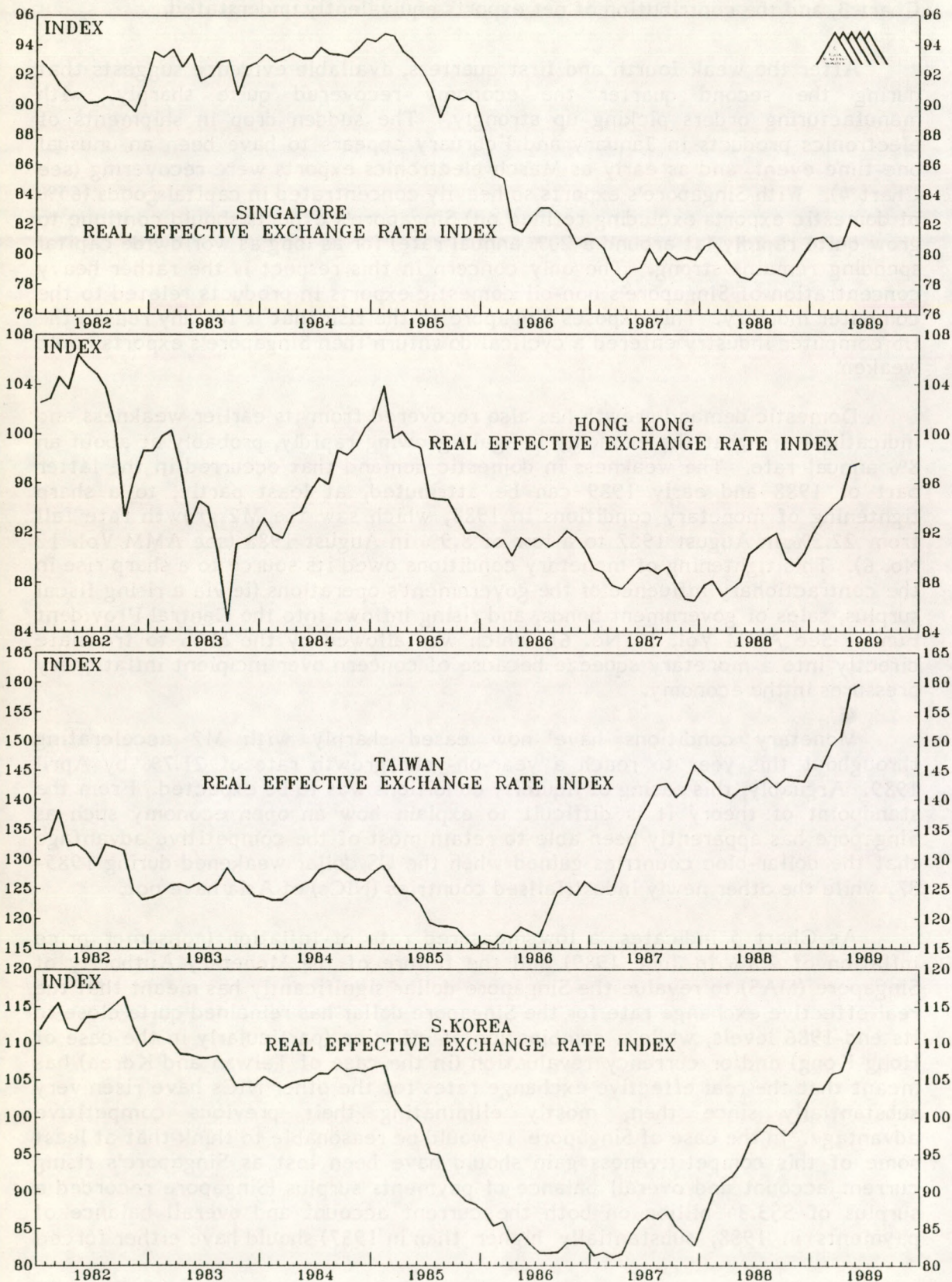
After the weak fourth and first quarters, available evidence suggests that during the second quarter the economy recovered quite sharply, with manufacturing orders picking up strongly. The sudden drop in shipments of electronics products in January and February appears to have been an unusual one-time event, and as early as March electronics exports were recovering (see Chart 4). With Singapore's exports so heavily concentrated in capital goods (65% of domestic exports excluding refined oil) Singapore's exports should continue to grow quite rapidly (at around a 20% annual rate) for as long as worldwide capital spending remains strong. The only concern in this respect is the rather heavy concentration of Singapore's non-oil domestic exports in products related to the computer industry. This exposes Singapore to the risk that if for any reason the US computer industry entered a cyclical downturn then Singapore's exports could weaken.

Domestic demand growth has also recovered from its earlier weakness and indications are that the economy is again growing rapidly, probably at about an 8% annual rate. The weakness in domestic demand that occurred in the latter part of 1988 and early 1989 can be attributed, at least partly, to a sharp tightening of monetary conditions in 1988, which saw the M2 growth rate fall from 22.2% in August 1987 to a low of 8.9% in August 1988 (see AMM Vol. 12 No. 6). This tightening of monetary conditions owed its source to a sharp rise in the contractionary influence of the government's operations (ie via a rising fiscal surplus, sales of government bonds, and rising inflows into the Central Provident Fund - See AMM Vol. 12 No. 6), which was allowed by the MAS to translate directly into a monetary squeeze because of concern over incipient inflationary pressures in the economy.

Monetary conditions have now eased sharply with M2 accelerating throughout this year to reach a year-on-year growth rate of 21.7% by April 1989. Arguably, this easing of liquidity conditions was to be expected. From the standpoint of theory it is difficult to explain how an open economy such as Singapore has apparently been able to retain most of the competitive advantage that the dollar-bloc countries gained when the US dollar weakened during 1985-87, while the other newly industrialised countries (NICs) of Asia have not.

As Chart 5 indicates, a low measured rate of inflation (consumer price inflation of 2.8% in June 1989) and the failure of the Monetary Authority of Singapore (MAS) to revalue the Singapore dollar significantly has meant that the real effective exchange rate for the Singapore dollar has remained quite close to its end-1986 levels, while a combination of inflation (particularly in the case of Hong Kong) and/or currency revaluation (in the case of Taiwan and Korea) has meant that the real effective exchange rates for the other NICs have risen very substantially since then, mostly eliminating their previous competitive advantage. In the case of Singapore, it would be reasonable to think that at least some of this competitiveness gain should have been lost as Singapore's rising current account and overall balance of payments surplus (Singapore recorded a surplus of S\$3.34 billion on both the current account and overall balance of payments in 1988, substantially higher than in 1987) should have either forced

SINGAPORE: CHART 5 REAL EFFECTIVE EXCHANGE RATES FOR THE NICs



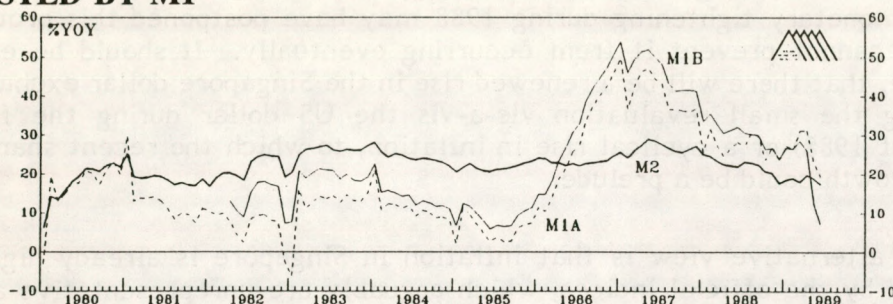
some more revaluation of the exchange rate or, alternatively, led to rising money growth and higher inflation. It appears that the government and MAS induced monetary tightening during 1988 may have postponed this process, but probably cannot prevent it from occurring eventually. It should be expected, therefore, that there will be a renewed rise in the Singapore dollar exchange rate (following the small revaluation vis-a-vis the US dollar during the final two months of 1988) or a cyclical rise in inflation, to which the recent sharp rise in money growth could be a prelude.

An alternative view is that inflation in Singapore is already higher than measured by the official indices, which arguably are unrepresentative and that, therefore, the calculations in Chart 5 over-estimate the degree to which Singapore has been gaining a competitive advantage vis-a-vis the other NICs. However, this view is not really supported by the deflators of the GDP components, which show only low increases in 1988. The export price deflator, in particular, fell marginally over the year.

The key point to note here is that the underlying cause of incipient inflationary pressures is the process of adjustment to Singapore's increased competitiveness, not pressures emerging in the labour market in Singapore per se. Singapore's labour market has tightened very significantly during 1989. Previously during this economic expansion an important source of growth of Singapore's labour force has been foreign workers, particularly contract workers from Malaysia. However most companies are now approaching the legislated ceilings for the ratio of foreign contract workers to local workers (foreign workers should not exceed a 1:2 ratio to local workers for any individual company) and, in addition, the government has recently increased the monthly levy on foreign workers from S\$220 to S\$250 per foreign worker. Nevertheless, slower growth in the labour force from now on will not in itself increase Singapore's inflation rate but will instead reduce the Singapore economy's achievable long-run rate of economic growth. Given that Singapore is essentially a fixed exchange rate economy, increases in wages are only possible in the long-run to the extent that they are not associated with the balance of payments moving into chronic deficit. In these circumstances companies which find it difficult to maintain profitability in the face of rising real wages must either switch to more capital intensive modes of production or go out of business.

FORECAST: To conclude, the Singapore economy is now recovering from a temporary lull in its rapid growth during the fourth quarter of 1988 and first quarter of this year. Weakness in domestic demand during those two quarters followed a period of very tight money conditions, now reversed as money growth is currently rising sharply. Although tight money during 1988 has probably helped to extend this economic expansion for Singapore, the current rise in money growth is likely to be followed by the emergence of some inflationary pressures in the economy. This is to be expected because, to date, Singapore has retained the competitive advantage gained from dollar weakness during 1985-87, an advantage which other NICs have already been losing for two years. The Monetary Authority of Singapore is likely to attempt to head off any possible rise in inflation by gradually revaluing the Singapore dollar later this year.

TAIWAN: MONETARY CONDITIONS ARE NOT AS TIGHT AS SUGGESTED BY M1

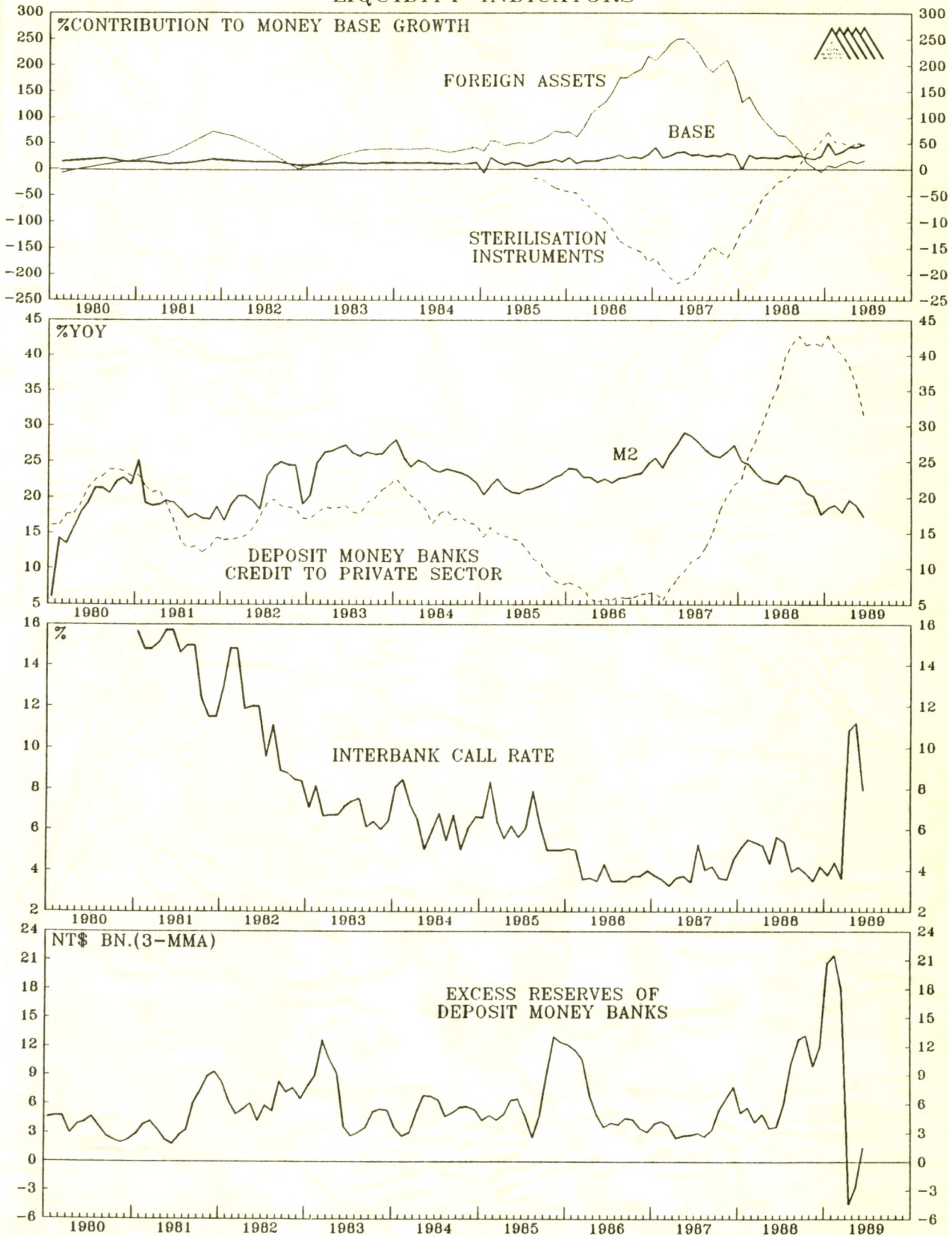


Following the Central Bank of China's (CBC) liquidity tightening measures enacted on April 1st, the growth of the narrow money aggregates fell sharply in April and May. By June the year-on-year growth rate of M1A had fallen to 19.3%, from 31.2% in March. The growth rate of M1B collapsed to 7.2%, M1B contracting by 10.7% from its March level. However, the impact of the CBC's measures on broad money growth was not nearly so marked, although M2 growth continued its cyclical decline, falling to 17.3% year-on-year in June. According to the CBC the adjusted monetary base continued to grow quite rapidly, growing at an annual rate of 20.1% in May and 25.6% in June.

The collapse in narrow money stemmed from a large scale shift of deposits from passbook accounts, particularly passbook savings accounts, to short-term time deposits. Individuals holding large deposits were encouraged to move their money from passbook savings accounts into one and three month time deposits because of a marked change in the interest rate structure, engendered by the CBC's measures, favouring the latter type of deposits. Following the large increase in reserve requirements on April 1st - the second such increase in four months - money market interest rates rose extremely sharply as banks found themselves unable to meet the new reserve requirements. The required reserve ratio for passbook savings deposits, already much higher than for time deposits, was raised proportionately more than for any other class of deposit, from 16% to 20%. Banks responded by sharply raising deposit interest rates for time deposits, from 4.5% in March to the ceiling level of 9.25% by May. But the rise in passbook savings deposit rates from 3.5% to 4.25% was comparatively marginal, reflecting the much higher reserve ratio and the banks' difficulty in meeting reserve requirements. Individuals consequently moved funds from passbook savings to 1 and 3 month time deposits, there being no incentive to extend deposit maturities beyond 3 months because all time deposit rates had risen to the same ceiling level (interest rate ceilings have subsequently been abolished as a result of the new banking law, which came into force in July). As a result passbook savings (included in M1B and M2 but not M1A) fell from comprising 17.3% of M2 at the end of March to 13.0% of M2 at the end of May while 1 and 3 month time deposits (included only in M2) rose from 3.7% to 16.8% of M2. This deposit switch accounted for the collapse in M1B (of which passbook savings previously accounted for over 40%).

Notwithstanding the distortions caused by the large shifts of deposits monetary conditions have clearly been tightening in Taiwan. However, a truer guide to the degree of monetary tightening is given by the behaviour of M2 and the adjusted monetary base, not by the behaviour of the narrow money aggregates.

TAIWAN LIQUIDITY INDICATORS







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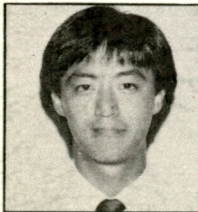
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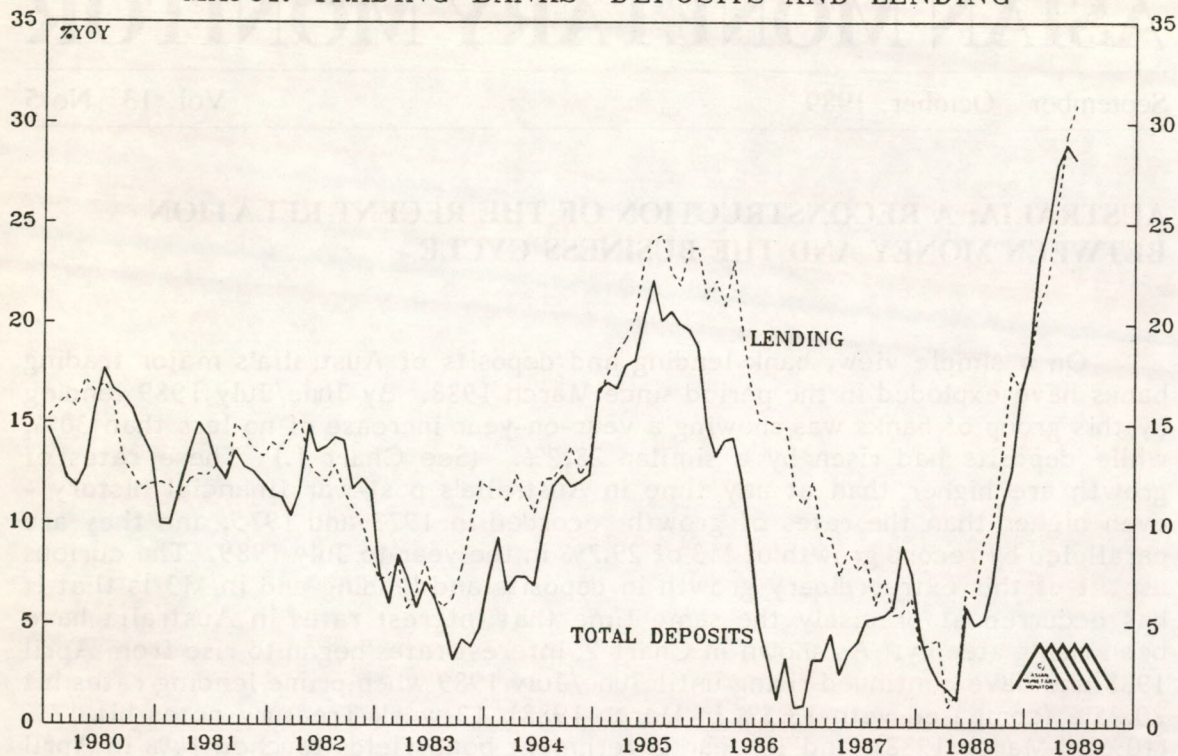
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AUSTRALIA: A RECONSTRUCTION OF THE RECENT RELATION BETWEEN MONEY AND THE BUSINESS CYCLE

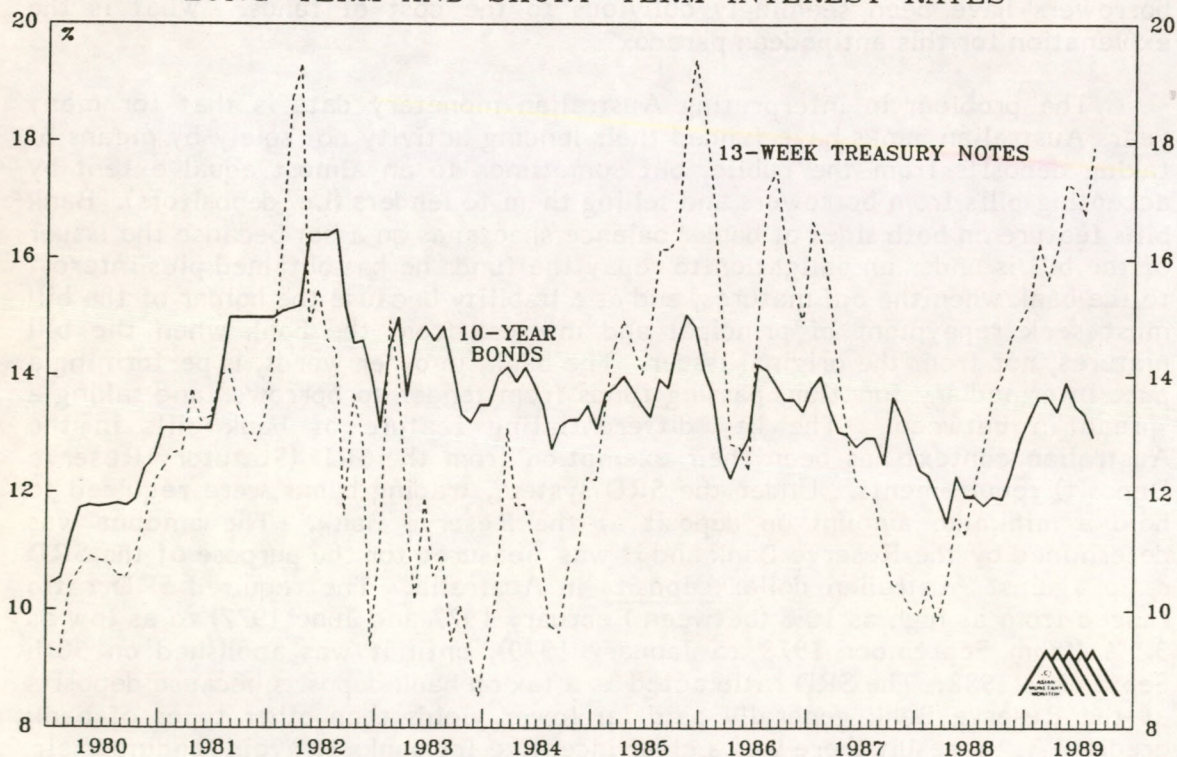
On a simple view, bank lending and deposits of Australia's major trading banks have exploded in the period since March 1988. By June/July 1989 lending by this group of banks was showing a year-on-year increase of no less than 30%, while deposits had risen by a similar 28.2%. (See Chart 1.) These rates of growth are higher than at any time in Australia's post-war financial history - even higher than the rates of growth recorded in 1973 and 1975, and they are paralleled by record growth of M3 of 29.7% in the year to July 1989. The curious aspect of this extraordinary growth in deposits and lending and in M3 is that it has occurred at precisely the same time that interest rates in Australia have been rising steeply. As shown in Chart 2, interest rates began to rise from April 1988 and have continued rising until June/July 1989 when prime lending rates hit 20.25% (compared with 13.5% in March 1988), 13-week Treasury notes hit 17% (10% in March 1988), and 10 year government bond yields touched 14% in April compared with 11.8% in March 1988. In short, despite a sharply inverted yield curve and a substantial rise of 700 basis points in the absolute level of short term interest rates, lending and borrowing have apparently been booming - i.e. borrowers have been seemingly oblivious to the cost of funds. What is the explanation for this antipodean paradox?

The problem in interpreting Australian monetary data is that for many years Australian banks have funded their lending activity not solely by means of taking deposits from the public, but sometimes to an almost equal extent by accepting bills from borrowers and selling them to lenders (i.e. depositors). Bank bills feature on both sides of banks' balance sheets: as an asset because the issuer of the bill is under an obligation to repay the funds he has obtained plus interest to the bank when the bill matures, and as a liability because the holder of the bill must seek repayment of principal and interest from the bank when the bill matures, not from the original issuer. The bank, in other words, is performing a pure intermediary function, passing funds from lender to borrower and taking a spread in between. The key differentiating feature of bank bills in the Australian context has been their exemption from the SRD (Statutory Reserve Deposit) requirements. Under the SRD system, trading banks were required to hold a minimum amount on deposit at the Reserve Bank. The amount was determined by the Reserve Bank and it was measured for the purpose of the SRD ratio against Australian dollar deposits in Australia. The required SRD ratio ranged from as high as 10% (between February 1977 and June 1977) to as low as 3.5% (from September 1978 to January 1979), until it was abolished on 30th September 1988. The SRD ratio acted as a tax on bank deposits because deposits at the Reserve Bank generally paid far lower yields than other types of bank credit. As a result there was a clear incentive for banks to avoid funding their

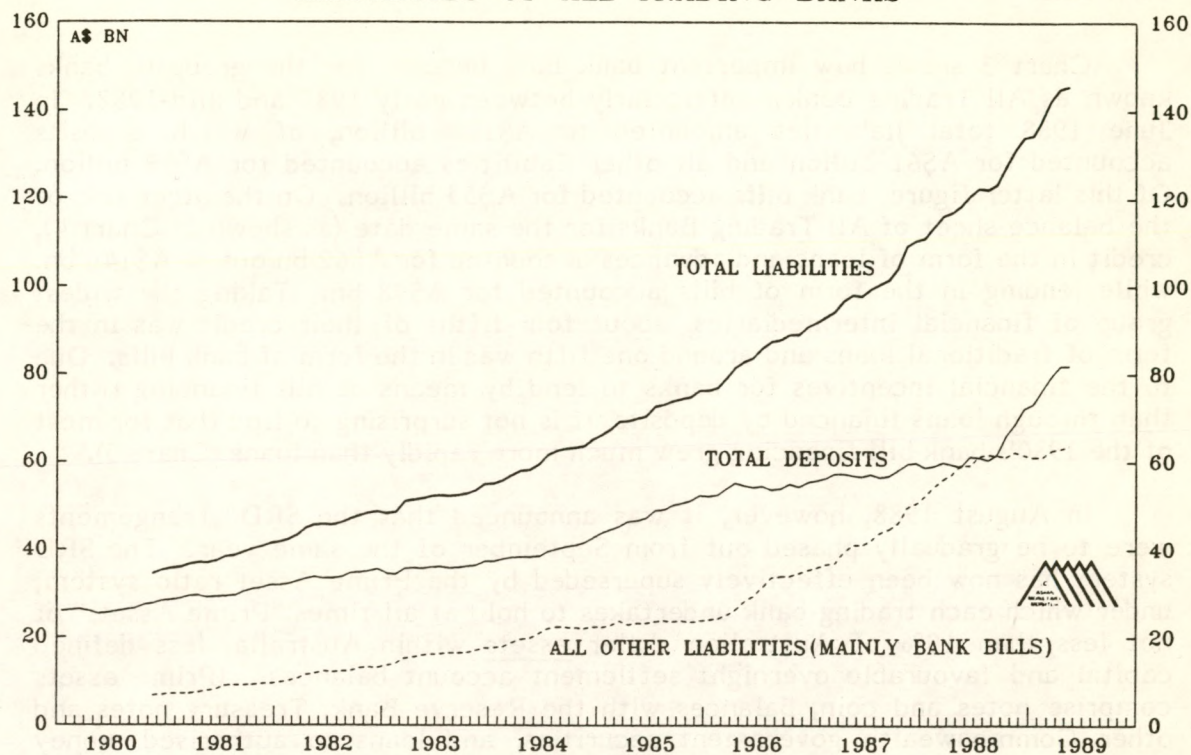
AUSTRALIA: CHART 1
MAJOR TRADING BANKS' DEPOSITS AND LENDING



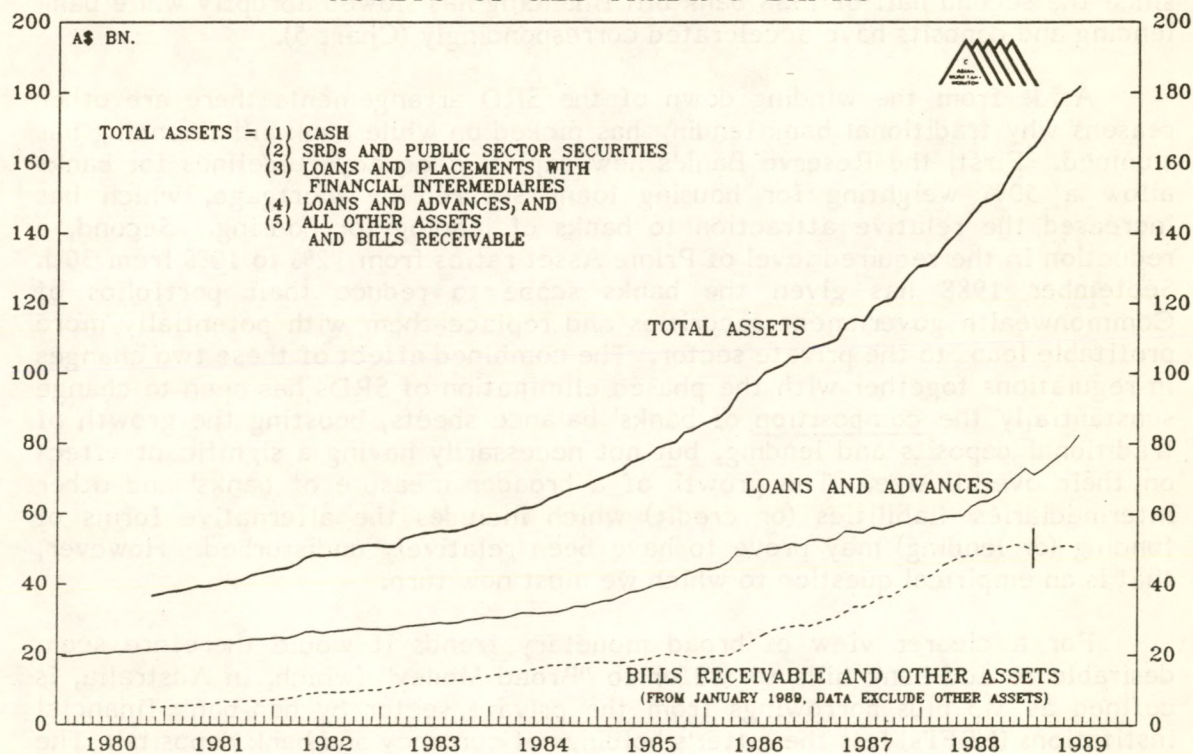
AUSTRALIA: CHART 2
LONG-TERM AND SHORT-TERM INTEREST RATES



AUSTRALIA: CHART 3
LIABILITIES OF ALL TRADING BANKS



AUSTRALIA: CHART 4
ASSETS OF ALL TRADING BANKS



loan customers via deposits, and to fund instead through other devices such as bank bills.

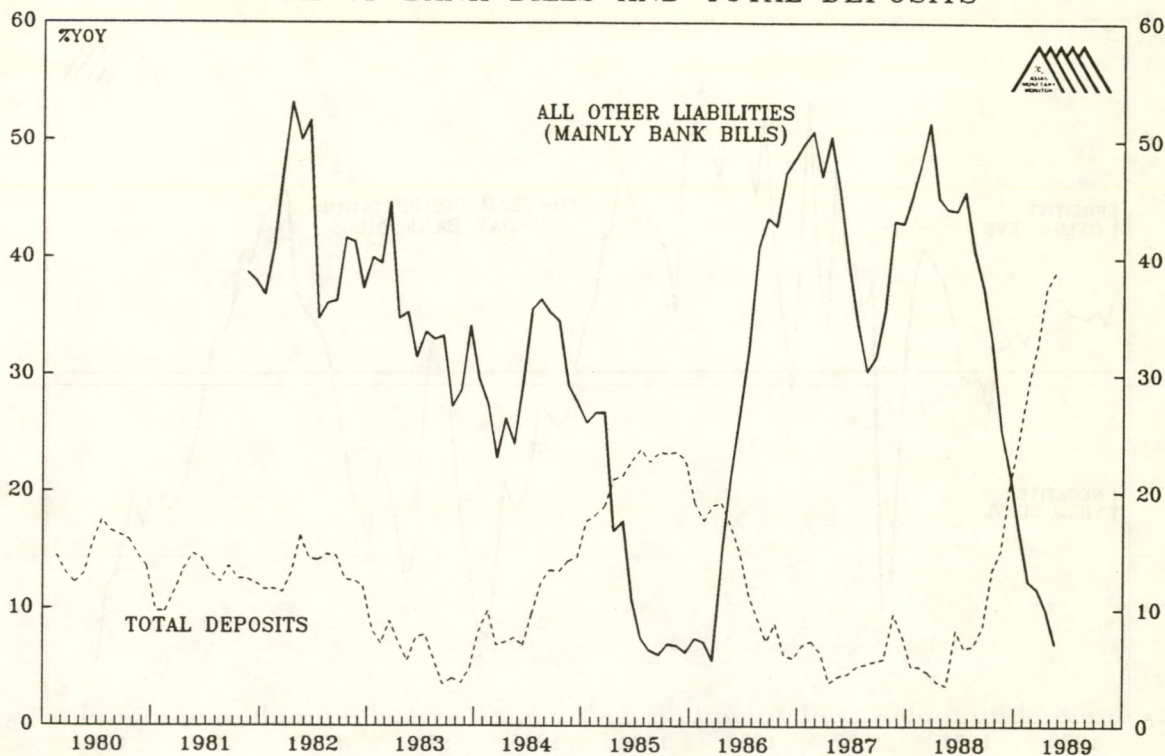
Chart 3 shows how important bank bills became for the group of banks known as All Trading Banks, particularly between early 1986 and mid-1988. In June 1988 total liabilities amounted to A\$120 billion, of which deposits accounted for A\$61 billion and all other liabilities accounted for A\$59 billion. Of this latter figure, bank bills accounted for A\$55 billion. On the other side of the balance sheet of All Trading Banks for the same date (as shown in Chart 4), credit in the form of loans and advances accounted for A\$62 bn out of A\$146 bn, while lending in the form of bills accounted for A\$48 bn. Taking the widest group of financial intermediaries, about four-fifths of their credit was in the form of traditional loans and around one fifth was in the form of bank bills. Due to the financial incentives for banks to lend by means of bill financing rather than through loans financed by deposits, it is not surprising to find that for most of the 1980's bank bill financing grew much more rapidly than loans (Chart 5).

In August 1988, however, it was announced that the SRD arrangements were to be gradually phased out from September of the same year. The SRD system has now been effectively superseded by the Prime Asset ratio system, under which each trading bank undertakes to hold at all times "Prime Assets" of not less than 10% of Australian dollar assets within Australia, less defined capital and favourable overnight settlement account balances. (Prime assets comprise notes and coin, balances with the Reserve Bank, Treasury notes and other Commonwealth government securities, and loans to authorised money market dealers secured against Commonwealth government securities.) The new system does not discriminate among types of liabilities in the way that the SRD system discriminated against deposits and in favour of bank bills. As a result, since the second half of 1988 bank bill financing has slowed abruptly while bank lending and deposits have accelerated correspondingly (Chart 5).

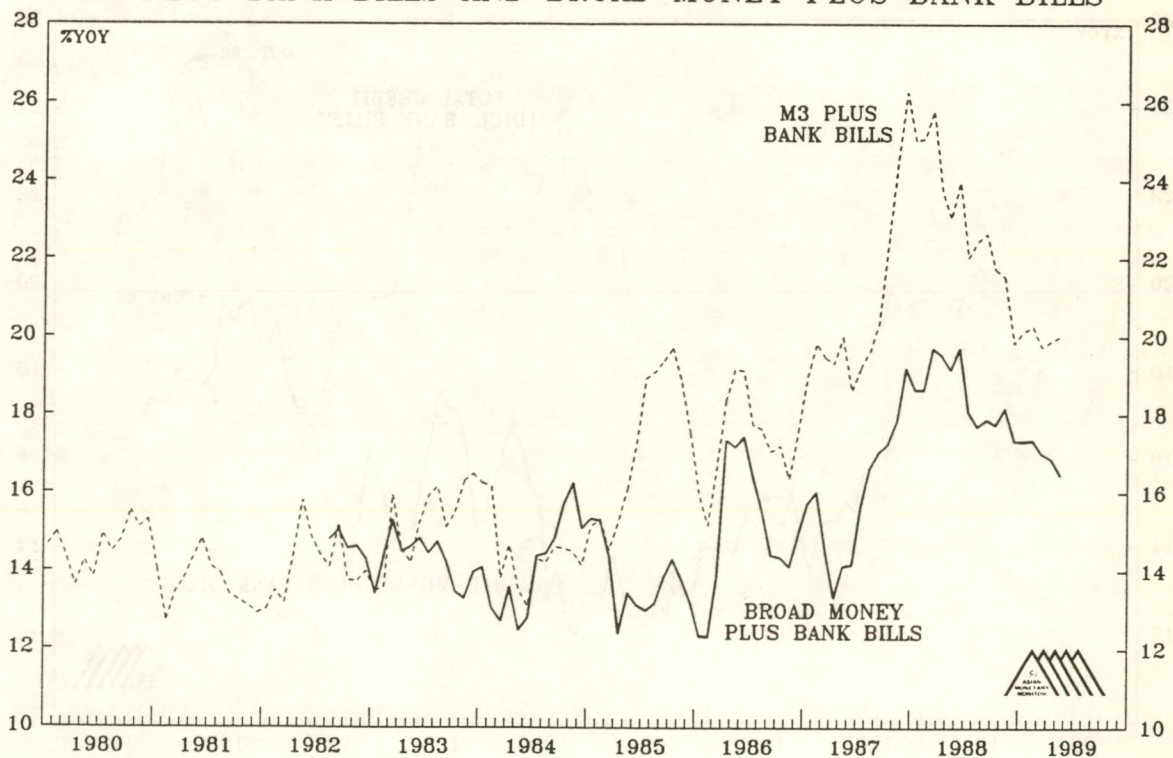
Aside from the winding down of the SRD arrangements there are other reasons why traditional bank lending has picked up while bank bill financing has slumped. First, the Reserve Bank's new capital adequacy guidelines for banks allow a 50% weighting for housing loans secured by mortgage, which has increased the relative attraction to banks of lending for housing. Second, a reduction in the required level of Prime Asset ratios from 12% to 10% from 30th September 1988 has given the banks scope to reduce their portfolios of Commonwealth government securities and replace them with potentially more profitable loans to the private sector. The combined effect of these two changes in regulations together with the phased elimination of SRDs has been to change substantially the composition of banks' balance sheets, boosting the growth of traditional deposits and lending, but not necessarily having a significant effect on their overall size. The growth of a broader measure of banks' and other intermediaries' liabilities (or credit) which includes the alternative forms of funding (or lending) may prove to have been relatively undisturbed. However, that is an empirical question to which we must now turn.

For a clearer view of broad monetary trends it would therefore seem desirable to add bank bills to M3 or to "Broad Money" (which, in Australia, is defined as M3 plus borrowings from the private sector by non-bank financial institutions (NBFIs) less the latter's holdings of currency and bank deposits). The

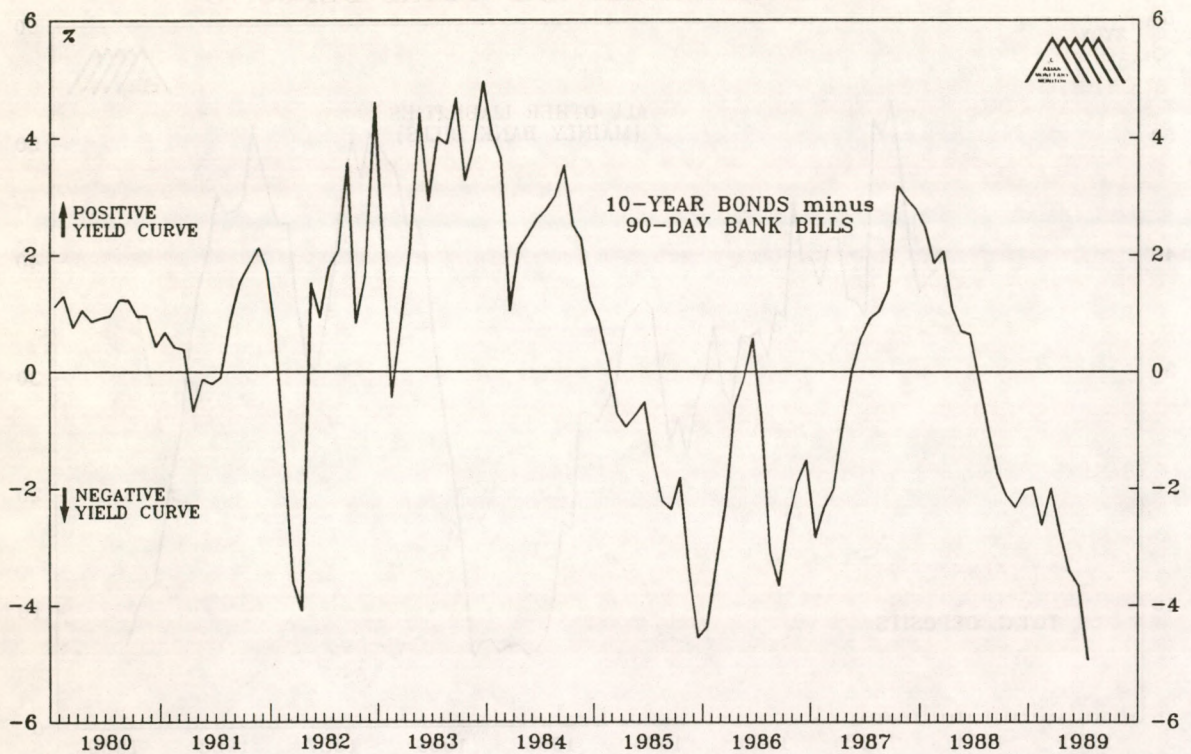
AUSTRALIA: CHART 5
GROWTH OF BANK BILLS AND TOTAL DEPOSITS



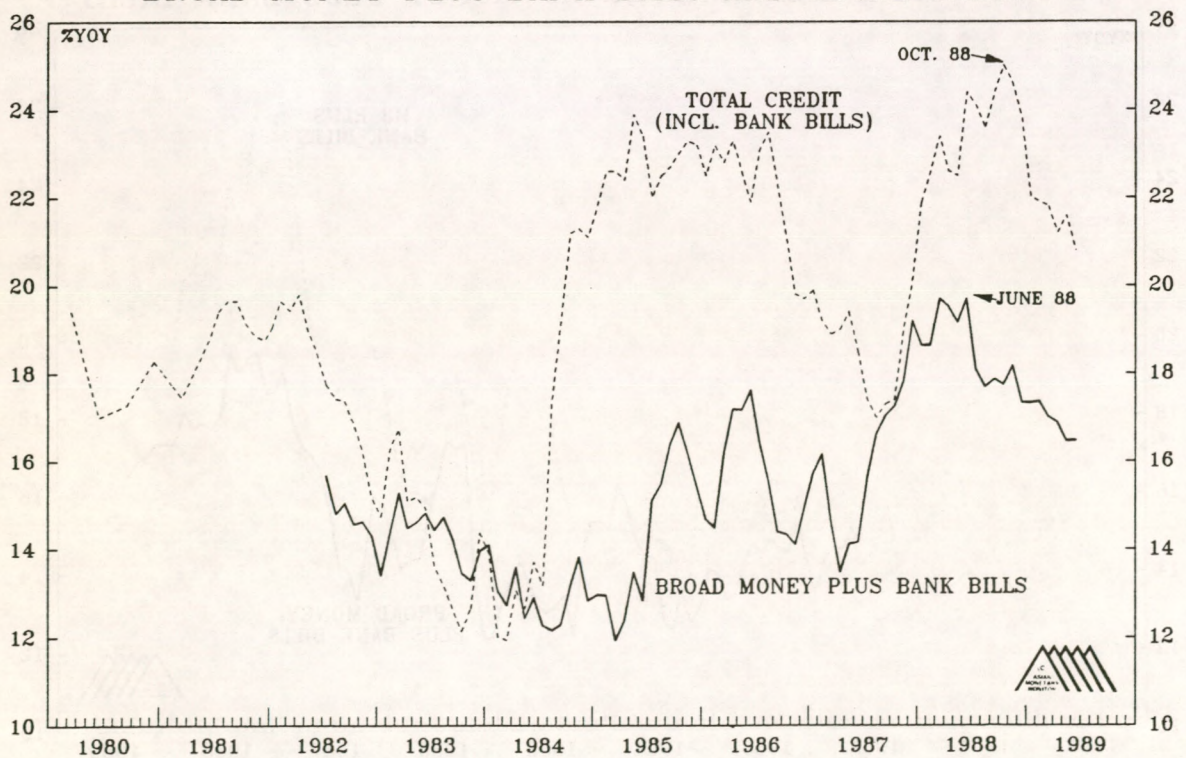
AUSTRALIA: CHART 6
M3 PLUS BANK BILLS AND BROAD MONEY PLUS BANK BILLS



AUSTRALIA: CHART 7
THE SHAPE OF THE YIELD CURVE



AUSTRALIA: CHART 8
BROAD MONEY PLUS BANK BILLS AND TOTAL CREDIT



results are shown in Chart 6 which plots the year-on-year rates of change for M3 plus bank bills (M3+BB) and Broad Money plus bank Bills (BM+BB). Even the most cursory glance suggests that the recent history of monetary behaviour is vastly different from that reported in Chart 1. By either definition there was a sharp acceleration in the amount of funding available to the banks (i.e. the monetary assets of the non-bank public) between early 1987 and mid-1988. Interestingly, this increase in the rate of growth of loanable funds precisely coincides with the fall in interest rates over the same period. Not only did 13-week Treasury note rates fall by over 700 basis points (from 17% in January 1987 to below 10% by March 1988) over this period, but in addition the shape of the yield curve went from being sharply inverted to being strongly positive. (See Chart 7.) To capture the story more fully it is necessary to look also at what has happened on the asset side of banks' balance sheets. This is reflected in Chart 8 which shows the behaviour of Total Credit (including bank bills) alongside the behaviour of Broad Money plus bank bills. Once again the period of falling interest rates and the move to a positively-sloped yield curve between early 1987 and mid-1988 exactly coincides with a substantial acceleration in the growth of these two aggregates. In other words, the sharp fall in interest rates in 1987-88 encouraged a huge increase in loan demand, and Broad Money plus bank bills increased almost *pari passu* with it.

Conversely, the paradox pointed to above of steeply rising interest rates against a background of rapidly accelerating M3 and Broad Money between April 1988 and the middle of 1989 now becomes entirely explicable. The powerful acceleration of "Super-Broad Money" (BM+BB) and the corresponding acceleration of Total Credit in 1987-88 would have encouraged very strong growth in all forms of spending after some lag. In fact, as shown in Chart 9, real GNP accelerated from almost zero in the first quarter of 1987 to 10% (year-on-year) by the first quarter of 1989. Over the same period nominal GNP surged from 8% to 16%. Thus when the authorities decided in April 1988 to start raising short term interest rates they had to cope with a situation in which real and nominal spending, stimulated by the surge in total credit and "super broad" monetary growth, were experiencing one of their strongest upswings of the 1970s and 1980s. Against this background it is not at all surprising (i) that interest rates in Australia have had to rise so high, (ii) that economic activity has continued to be so buoyant in so many sectors despite the high level of interest rates, or (iii) that the external current account deficit is running at a record 7% of GDP.

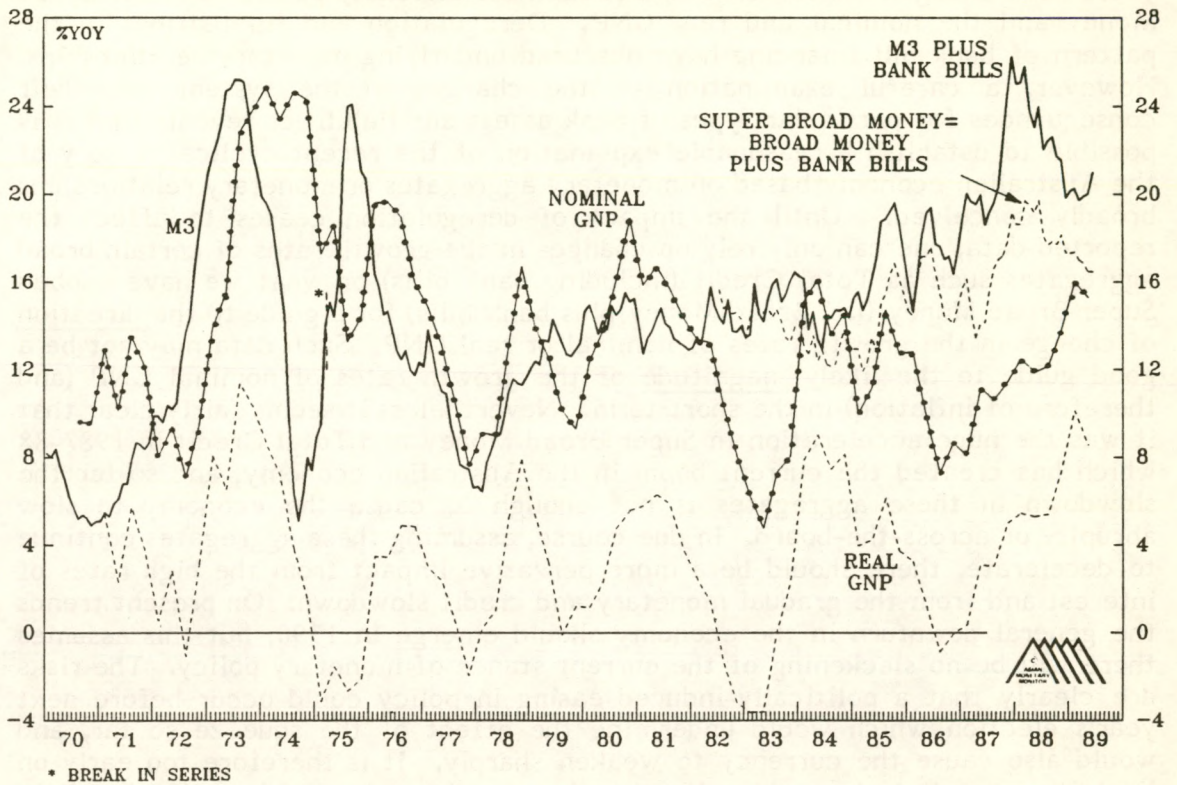
When will the Australian economy begin to peak out and weaken across a broad front? The answer can only be established by reference to the past relationships between the appropriate monetary aggregate and nominal or real GNP in Australia. Charts 9 and 10 therefore show the long term behaviour of these different magnitudes between 1970 and 1989.

In Chart 9 the series for M3 plus bank bills is consistent throughout most of the period since bank bill financing only started to be separately reported in 1974. Between 1970 and 1978 this measure of money was an excellent leading indicator or guide to real and nominal GNP. The only surprise in this period is how short the lag between money and GNP was in 1977-78. From 1979 the relationship starts to become less reliable. There is a clear downturn in nominal and real GNP in 1979 - perhaps due to the second round of OPEC oil price hikes -

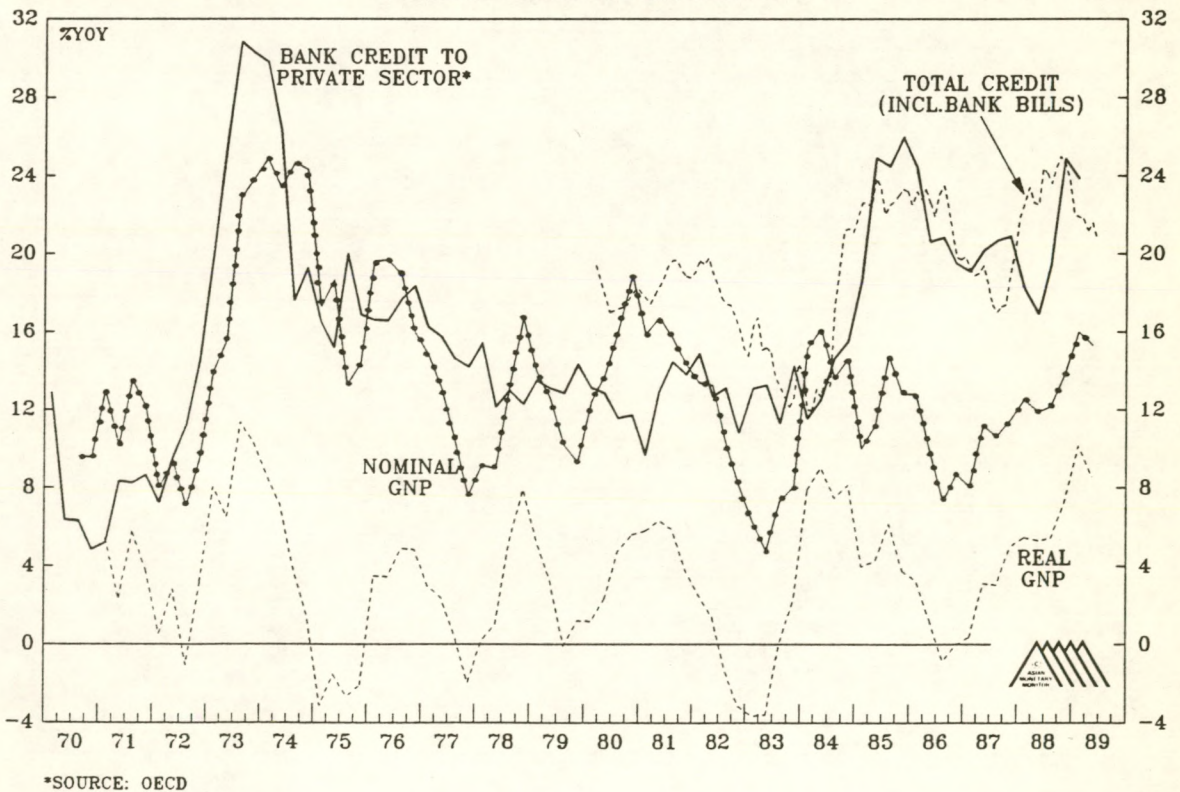
which was not associated with any downturn in money (M3 plus bank bills), and again in 1982-83 and in 1986 the downturns in nominal and real GNP cannot be explained by any corresponding downturns in monetary growth. By this stage Australian financial markets were being liberalised and deregulated, and there were numerous changes occurring which were eroding the reliability of M3 or even M3 plus bank bills as a dependable monetary indicator. Not even Broad Money plus bank bills (which we have dubbed Super Broad Money) provides a very good guide to the cyclical fluctuations of nominal and real GNP since 1980. The only decisive episode comparable in terms of reliability to the past relationships is the acceleration of M3 plus bank bills and Super Broad Money in 1987-88 and the subsequent acceleration of nominal and real GNP described earlier. However, although Super Broad Money and M3 plus bank bills have been decelerating for 10 and 14 months respectively, no sustained downturn in nominal and real GNP has yet commenced. Nominal and real GNP are still responding to the strong stimulus of the 1987-1988 expansion in Super Broad Money and M3 plus bank bills. Consequently the question of the efficacy of the slowdown so far in the two monetary aggregates must await the outcome of the next 6-12 months before any judgment can be made.

Turning to the asset side of bank (and other intermediaries') balance sheets, the relation between the broadest credit indicators and nominal and real GNP for the period 1970-1989 is set out in Chart 10. It is immediately clear from this chart that a broad measure of bank credit to the private sector tracks nominal GNP reasonably closely from 1970 to 1984, though there are some significant deviations of nominal GNP from this measure of credit between 1977 and 1981, and in 1982-83. The decisive break in the whole chart comes in 1984 when the two credit measures move upwards sharply relative to nominal GNP, leaving a gap of approximately 2-4 percentage points between the growth rate of the credit aggregates and the growth rate of nominal GNP. This is a decisive break in the relationship and is almost certainly due to the innovations introduced into the Australian banking system during the early 1980's. It suggests that there has been an upward shift in the volume of financial intermediation which is still being reflected in relatively faster growth of the broad money and credit aggregates. However, the increased level of borrowing and lending is not likely to continue to grow faster than the nominal GNP indefinitely. Reverting to Chart 9, the same upward shift of Super Broad Money and M3 plus bank bills relative to nominal GNP between 1984 and 1988 is also apparent, the difference between Super Broad Money and nominal GNP being generally 2-3 percentage points, but it is noteworthy that the gap has narrowed to negligible proportions since the fourth quarter of 1988. As the impact of deregulation fades, one would expect the rates of growth of both the money and credit aggregates to return to levels much more similar to nominal GNP than in the period 1985-1988. In the meantime the direction of changes in the growth rates of the credit aggregates and the super-broad money aggregates will remain the best guides to the direction of changes in the growth rates of nominal and real GNP, even if their magnitudes are not for the time being an accurate predictor of nominal GNP growth rates.

AUSTRALIA: CHART 9
SUPER BROAD MONEY AND GNP



AUSTRALIA: CHART 10
TOTAL CREDIT AND GNP



FORECAST: Major changes in the Australian financial system in the past few years have changed the relationship between the officially published M3 or Broad Money and the nominal and real GNP. Deregulation and fluctuations in the pattern of bank bill financing have obscured underlying monetary relationships. However, a careful examination of the changes in the system and their consequences for particular types of bank assets and liabilities reveals that it is possible to establish a reasonable explanation of the recent cyclical history of the Australian economy based on monetary aggregates or monetary relationships broadly conceived. Until the impact of deregulation ceases to affect the reported data, one can only rely on changes in the growth rates of certain broad aggregates such as Total Credit (including bank bills) or what we have dubbed Super Broad Money (i.e. Broad Money plus bank bills) for a guide to the direction of change in the growth rates of nominal or real GNP. Such data may not be a good guide to the likely magnitude of the growth rates of nominal GNP (and therefore of inflation) in the short term. Nevertheless it seems fairly clear that it was the huge acceleration in Super Broad Money and Total Credit in 1987-88 which has created the current boom in the Australian economy, and so far the slowdown in these aggregates is not enough to cause the economy to slow abruptly or across-the-board. In due course, assuming these aggregates continue to decelerate, there should be a more pervasive impact from the high rates of interest and from the gradual monetary and credit slowdown. On present trends the general downturn in the economy should emerge in 1990, but this assumes there will be no slackening of the current stance of monetary policy. The risks are clearly that a politically-induced easing in policy could occur before next year's election which would undermine the effect of the squeeze so far, and would also cause the currency to weaken sharply. It is therefore too early on liquidity grounds to be making large-scale commitments to Australian bonds or equities, and holders of the currency should take note of the risks of depreciation should a premature easing of monetary policy occur.

EPISODES FROM ASIAN MONETARY HISTORY

A BRIEF HISTORY OF HONG KONG MONETARY STANDARDS

Hong Kong has had a number of monetary standards during its existence. Each had a different reserve base or a different relation between reserves and bank liabilities. A brief description of how each one worked serves as a good introduction to the merits and defects of Hong Kong's present monetary arrangements. The standards have been:

1. The silver coin standard, 1841-1845
2. The silver standard with unrestricted bank note issue, 1845-1895.
3. The silver standard with restricted bank note issue, 1895-1935
4. The inconvertible sterling exchange standard, 1935-1941
5. World War II duress issues, 1941-1945
6. The convertible sterling exchange standard, 1947-1972
7. The fixed rate U.S. dollar exchange standard, 1972-1974
8. The free issue standard, 1974-1983
9. The fiat U.S. dollar exchange standard mark I, 1983-1988
10. The fiat U.S. dollar exchange standard mark II, 1988-present

1. The silver coin standard, 1841-1845

When the British seized Hong Kong in 1841, the Spanish silver dollar was the dominant coin in southern China. To make change of amounts of less than a dollar, people used lumps of silver (including broken pieces of the dollar) or used copper 'cash' coins (Endacott, *The Hongkong Mint*, p. 744). Hong Kong passed its first currency ordinance in March 1842. The ordinance set legal tender values for the Spanish and Mexican silver dollars, the Indian silver rupee, and Chinese copper cash.

The Chinese preferred the Spanish silver dollar over other dollars of nearly the same silver content because they were more familiar with the Spanish coin. It circulated at a premium to the more plentiful Mexican dollar until 1853, when Canton switched to the Mexican dollar as its standard coin (King, Money...in China, p. 171). An 1844 ordinance to introduce British silver coins alongside the silver dollars had no effect, since the Chinese insisted on trading in dollars (Kann, p. 9).

There were no banks until 1845. Large commercial houses were the chief lenders and exchange brokers (Collis, p. 12). Hand-to-hand currency consisted of full-weight coins minted outside the colony. Hence the only way to meet an increase in the demand for currency was by generating a balance-of-payments surplus and importing coins. Goods arbitrage tended to make the purchasing power of silver uniform within the silver points. Depending on the distance, it became profitable to ship silver from place to place whenever the difference in purchasing power was 2 percent to 6 percent.

2. The silver standard with unrestricted bank note issue 1845-1895

Britain instructed Hong Kong in 1845 to introduce the gold-based pound sterling as the standard by revising the list of legal tender coins (Proclamation of 1st May 1845). However, the Spanish silver dollar retained its dominance; gold British sovereigns were at a discount of up to 30 percent to their legal tender value because the Chinese did not want them.

Although sovereigns were legal tender, people did not have to accept them in payments if they specified that they would only accept silver dollars. A Supreme Court decision of January 1854 confirmed that right (Endacott, 'Currency Problem', p. 517). The Oriental Bank, which opened the first Hong Kong bank branch in April 1845, printed a notice on its early note issues that they were payable in Spanish dollars. By 1863, Britain had conceded defeat in its attempt to impose sterling, and Hong Kong returned to the silver dollar as the legal basis of its currency.

By 1866 there were eleven banks in Hong Kong, of which six issued notes. The repercussions of the English and Indian financial panics of 1866 made six banks (not all note-issuing) fail or shut their Hong Kong branches. It was the only wave of bank failures that Hong Kong suffered for a century, though there were important failures by individual banks, such as the Oriental Bank in 1884 and the New Oriental Bank and the Chartered Mercantile Bank in 1892 (King, Money...in China, p. 99). Originally, the note issues of some banks were unregulated, because the banks operated as partnerships. All chartered banks had regulated note issue. They could not issue more notes than the amount of their paid-in capital, and had to deposit with the government for safekeeping a reserve in either gold or silver (depending on the terms of their charter) equal to one-third of the note issue. Chartered banks could not issue notes for less than \$5, except that the Hongkong Bank was allowed to issue some \$1 notes in 1872 to alleviate a scarcity of dollar coins (Ghose, pp. 3, 11-12).

The banks willingly accepted the note issue restrictions, for in return, they gained the great advantages of limited shareholder liability and official sanction for their notes. Bank notes were not legal tender in Hong Kong, but the government accepted the notes of chartered banks, and not of unchartered banks, for tax payments. Government acceptance of a bank's notes helped increase their acceptability among the populace at large (Ghose, p. 17).

The presence of banks broke the direct link that had existed under the silver coin standard between the currency supply and the balance of trade. Bank liabilities were a form of credit ('inside money'), whereas silver was a reserve medium ('outside money'). It was no longer necessary to produce a balance of trade surplus to increase the stock of currency, provided people wanted the currency in denominations of \$5 and up. Banks could meet an increased demand to hold currency by issuing more notes. If customers genuinely wanted the notes to hold, not to spend, the banks would not lose reserves from adverse clearings.

BANKS, 1845-1895

Assets	Liabilities
Silver	Notes
Loans	Deposits
	Equity

The exchange rate was the banks' responsibility. They were legally obligated to pay noteholders or depositors in whatever medium they had promised to use, whether Spanish silver dollars or other legal tender coins. The government had no role in 'defending' the currency.

The effects of balance of payments surpluses or deficits were different under the silver standard with banks than they were under the silver coin standard. Silver was at the apex of an inverted pyramid of credit, so changes in silver reserves would have 'multiplier' effects on the supply of credit. A balance of payments surplus, resulting in silver inflows, would give banks a higher reserve ratio than before, enabling them to expand loans by some multiple of the silver inflow. A rise in Hong Kong prices would follow as borrowers used the loans to bid up goods' prices. An outflow of silver would have the reverse effects. Having lost reserves, banks would have to contract loans to protect their solvency. Prices would fall because there would be fewer funds with which to bid up goods' prices.

3. The silver standard with restricted bank note issue, 1895-1935

By 1892, Hong Kong had only two note-issuing banks, the Hongkong Bank and the Chartered Bank - the only note-issuing banks today. In 1895, Hong Kong passed an ordinance (No. 2) that prohibited note issue without local government approval. The ordinance prevented British colonial banks with note-issuing powers granted in London from exercising those powers unless they had the Hong Kong government's approval.

There was a strong demand for bank notes. The Chartered Bank in 1894 and 1897 increased its capital and note issue. The Hongkong and Shanghai Bank met the demand by exceeding its statutory note issue limits. On discovering what the bank had done, the government allowed it to continue excess note issues as long as it kept a 100 percent marginal silver reserve (King, Money...in China, p. 105). The Chartered Bank received similar powers in 1902, but they were withdrawn in 1922. The Mercantile Bank, which opened in 1912, was not allowed any excess issue (Stammer, p. 30). The Hongkong and Shanghai Bank had about 90 percent of the total note issue.

The restrictions on note issue applied the ideas of the British Currency School economists, who had succeeded in getting similar laws passed in England a half-century before. However, the rationale for the restrictions was unsound. There is no need for special restrictions on note issue. Under any banking system with a limited quantity of reserves, the supply of notes, like the supply of deposits, is self-regulating.

Hong Kong's note supply would have been adequate if the notes had only circulated within the colony. However, much of the circulation was in China,

where the notes were esteemed because of their convenience and the banks' good reputations. That explains why the per capita note circulation of Hong Kong about 1929 was \$85, versus \$47 for the Straits Settlements (Kann, p. 29).

By the late 1890s, bank notes went to a premium over silver dollars, though the premium caused no serious inconvenience till 1908, when it reached 3½ percent (Report of the Currency Committee, 1930, para. 12). Removing the reserve requirements on note issues and eliminating the 1 percent stamp tax on notes would have eliminated the premium, but the government was beholden to Currency School doctrine. As alternative measures, it considered but rejected the idea of issuing its own notes, and in 1911, permitted the Mercantile Bank of India to start issuing notes (Ordinance No. 65). Its actions were insufficient to prevent the bank note premium from recurring. During World War I, the premium nearly disappeared as silver shipments from the West were cut off, but it returned after the war. In September 1929, it reached a peak of 20 percent (Report of the Currency Committee, para. 12). In 1929, the banks agreed to reestablish parity between silver dollars and bank notes (Kann, p. 19). By 1931, the rate for notes had fallen to within the silver points (King, HSBC, Vol. 3, p. 248), though the premium later returned (Cribb, p. 74).

BANKS in 1895-1935

Assets	Liabilities
Silver	Fiduciary Note Issue
100% Silver Holding	Excess Note Issue
against Excess Note Issue	Deposits
Loans	Equity

Banks maintained a dual currency system to prevent customers from arbitraging the difference between bank notes and coins. Customers who deposited notes or checks could withdraw either notes or coins, while customers who deposited coins could only withdraw coins. The system had official support: the British government, supporting the Hongkong Bank's protests, instructed the military treasurer to desist from trying to deposit silver and withdraw bank notes (King, HSBC, Vol. 2, pp. 210-211).

At the same time that bank notes were at a premium to the silver dollar, Hong Kong government-issued subsidiary coins were at a discount to it. Issued from 1866 to 1868, and again from 1895 onward, the coins experienced wide swings in value. Though the silver subsidiary coins had silver worth 80 percent of their face value, they circulated at only 65 percent of face value at one point in the 1860s. At other times, they were at a premium to face value. From 1904 to 1916, the glut of subsidiary coins was chronic, largely because the Chinese mint in Canton was issuing similar coins. The government retired subsidiary coins from circulation from 1908 to 1910, but the discount persisted. Finally, in 1912 Hong Kong's tram company announced that it would not accept Canton coins at par with Hong Kong coins. Hong Kong Chinese saw the company's action as an affront to China's new Republican government. They organised an effective boycott of the tram company that was broken only because the government intervened. The following year, Hong Kong passed ordinances (1913, Nos. 13 and 15) prohibiting foreign notes or coins from circulating in Hong Kong without

express government permission. (See 'Hong Kong: Cashing in on Small Change', AMM, July-August 1979). (The notes prohibition was repealed in 1984.)

4. The inconvertible sterling exchange standard, 1935-1941

In the 1870s, silver's value relative to gold began to fall as many countries switched from the silver standard to the gold standard. Over the next half-century, silver dropped to as low as one-fourth of its gold value at the start of the period. Many London-based Eastern exchange banks suffered a profit squeeze. Their capital had been raised in Britain and paid in gold, but many of their loans were made in Asia in silver. Reckoned in gold, their assets were shrinking. The Hongkong Bank, whose capital had been paid in silver, was an exception (Ghose, p. 7).

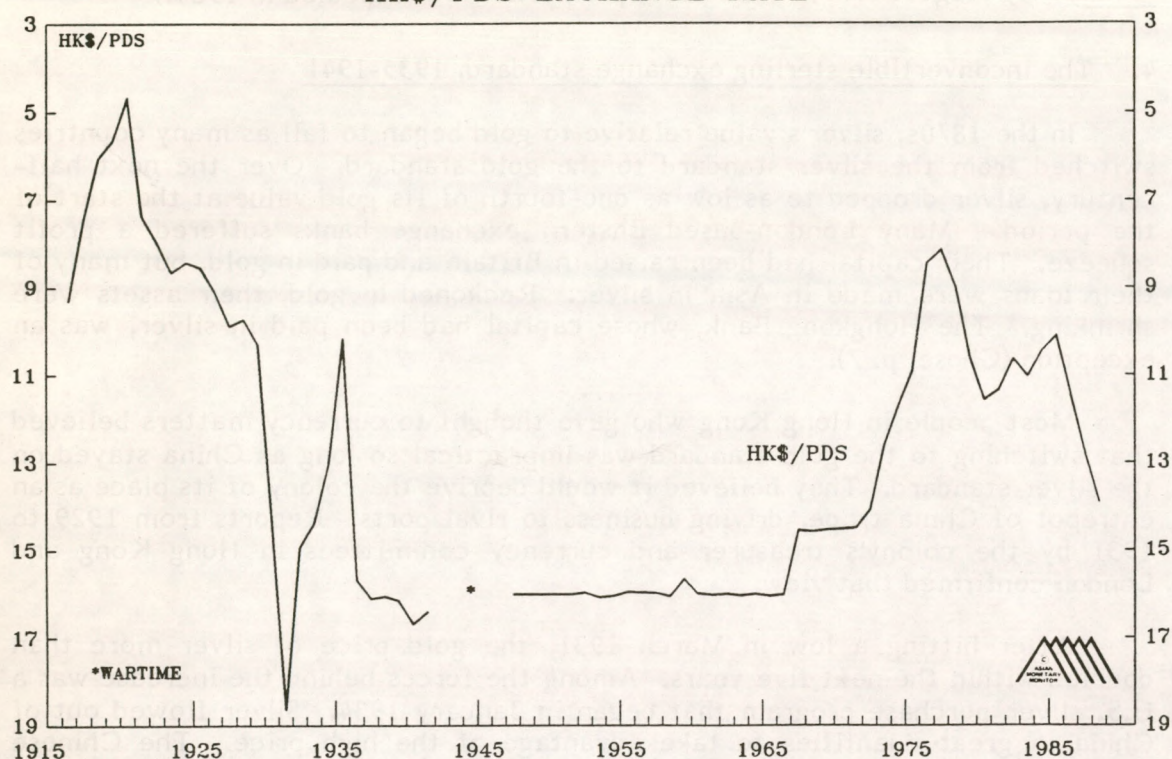
Most people in Hong Kong who gave thought to currency matters believed that switching to the gold standard was impractical so long as China stayed on the silver standard. They believed it would deprive the colony of its place as an entrepot of China trade, driving business to rival ports. Reports from 1929 to 1931 by the colony's treasurer and currency committees in Hong Kong and London confirmed that view.

After hitting a low in March 1931, the gold price of silver more than doubled within the next five years. Among the forces behind the increase was a U.S. silver purchase program that began in January 1934. Silver flowed out of China in great quantities to take advantage of the high price. The Chinese government saw an opportunity to switch standards profitably. On November 3, 1935, China demonetised and nationalised all silver holdings, and made the note issues of government banks the sole legal tender. It sold the silver on world markets, making a tidy profit. Instead of using the gold-denominated assets thus raised as reserves for the currency, as it promised, it spent them. China was left with a fiat currency rather than with the gold standard that some currency reformers had hoped for.

Hong Kong's immediate response was to pass an ordinance (No. 42) providing for government issue of inconvertible \$1 notes to offset the shrinking supply of silver dollar coins. On December 6, it abandoned the silver standard. The Currency Ordinance (No. 54) nationalised all silver holdings, except those of jewelers and other commercial users, and made the notes of each issuing bank legal tender. A new government body, the Exchange Fund, took control of the silver, which amounted to about 12.3 million sterling (Ghose, p. 15). It was empowered to hold Hong Kong dollars, any foreign currency, gold, silver, or assets approved by the Colonial Office (i.e. denominated in sterling). In return for the silver that the banks handed over, the Exchange Fund gave them Hong Kong dollar denominated non-interest-bearing Certificates of Indebtedness, which they could use as backing for their note issues in the same way that they had previously used silver.

When the note-issuing banks subsequently wanted to buy Certificates of Indebtedness as backing for note issue, they paid the Exchange Fund with sterling or Hong Kong dollars. Banks that did not issue notes could buy them from the note-issuing banks with the sterling or Hong Kong dollars. In practice, the Exchange Fund insisted on payment in sterling rather than Hong Kong dollars on

HONG KONG: CHART 1 HK\$/PDS EXCHANGE RATE



all but a few occasions until the Hong Kong dollar was unlinked from sterling in 1972.

The Exchange Fund had no legal obligation to fix the value of the Hong Kong dollar at any particular rate. The market rate for sterling when the Fund began was 1s.:3-5/8d. (\$15.36 = 1 pound sterling), and the Fund decided to stabilise the local currency at approximately that level. Over the next few years, the sterling exchange rate ranged from that rate to a low of 1s.:2-19/32d. (\$16.45 = 1 pound sterling.) (Stammer p. 59). In September 1939, the Fund announced that it would keep the rate within definite limits, though its promise was not legally binding. The note-issuing banks sold sterling to the Exchange Fund at 1s.:2-13/16d, and bought at 1s.:3d. per Hong Kong dollar (\$16.20 and \$16.00 per 1 pound sterling, respectively). The selling rate was later increased to 1s.:2-7/8d. (\$16.13 per 1 pound sterling), narrowing the spread, and in the late 1960s, increased again to 1s.:3d, eliminating the spread. Other banks could not deal with the Exchange Fund directly. They had to go through the note-issuing banks, which added another 1/32d. (3.3 cents per pound) in either direction to the Exchange Fund's spread. The public, in turn, faced a still wider spread of 1/32d. in either direction (Stammer, p. 61). The banks agreed to buy and sell all the sterling the public wanted at the agreed rate, so they had to make sure that their Hong Kong liabilities did not become so great that purchasing power differences made it attractive for customers to convert into sterling on a large scale.

The Exchange Fund held almost all of its assets in sterling and sterling

securities. The sterling exchange standard, also known as the colonial currency board system, was supposed to give colonies the benefit of convertibility (indirectly, through sterling) without the costs of holding a gold reserve that earned no interest. Instead, the currency board could earn interest on sterling securities, generating seignorage. As a sort of homage to British Currency School doctrine, colonial currency boards held assets worth 100 percent or more of the note issue. (See AMM, November-December 1982, on colonial currency boards.) Thanks to its confiscation of all silver, the Exchange Fund had reserves of at least 100 percent of its Certificate of Indebtedness liabilities from the start. It often donated the surplus in excess of 105 percent to the general revenue. The only difference between the Exchange Fund and other colonial currency boards was that they were monopoly note issuers, whereas it did not issue notes. (The \$1 note issue was technically separate, though in 1978 it was merged into the Exchange Fund.)

EXCHANGE FUND, 1935-1974, 1983-1988

Assets	Liabilities
Foreign Exchange	Certificates of Indebtedness for HK\$ Notes

BANKS, 1935-1974, 1983-1988

Assets	Liabilities
Certificates of Indebtedness Loans Foreign Exchange	Notes Deposits Equity

Money supply adjustment under a currency board was similar to money supply adjustment under the restricted bank note issue silver standard that Hong Kong had before. The important difference between the two systems in 1935 was that Britain was not on the gold standard; it had abandoned gold in September 1931. The public expected that Britain and the other nations that had abandoned gold would return to gold once their economies recovered from the Great Depression, thereby also restoring the convertibility of colonial currencies.

Establishing the Exchange Fund involved the government in day-to-day currency matters for the first time. By regulating the note issue, the government indirectly regulated deposits, because of their one-to-one convertibility into notes. Hence the note issue has ever since had an importance far out of proportion to its share of the money supply.

5. World War II duress issues, 1941-1945

When the Japanese captured Hong Kong in December 1941, they found \$121.9 million of unissued notes in bank vaults. (Total bank note issue at the time was about \$290 million; there were also over \$6 million of government 1 cent to \$1 notes.) All but \$2.1 million belonged to the Hongkong and Shanghai

Bank. It should have burned the notes, but the speed of Japan's invasion took it by surprise. The Japanese seized the notes and issued them without compensating the banks; hence these issues were called the 'duress notes'.

The British government, upon receiving news of the duress notes, announced that the Exchange Fund had no obligation to honour them. (The Fund's assets were all held safe in London.) Free China Radio broadcast warnings that the notes were illegal, and listed the serial numbers. For a time, duress notes passed at a discount of as much as two-thirds to legally issued notes (King, Monetary System of Hong Kong, pp. 21-2).

The occupation government also issued its own currency, the military yen, at a legal rate of 4 yen per dollar. Both the military yen and all the bank notes, legal and illegal, were fiat currencies. The occupation government also liquidated banks from countries at war with Japan, and restricted deposit withdrawals. In January 1943, it prohibited the circulation of Hong Kong dollar notes and made the military yen the only legal tender currency. However, the demand for Hong Kong dollar notes continued, because many people anticipated that they would be restored as legal tender if Japan lost the war (Jao, Banking and Currency in Hong Kong, pp. 16-17).

As the Allies drew closer to victory, the military yen lost value. By the end of the war, a plate of food cost 1,400 yen, and a packet of matches 30 yen. British intelligence estimated total Hong Kong military yen circulation at 1.8 billion yen (Braun, pp. 45, 103).

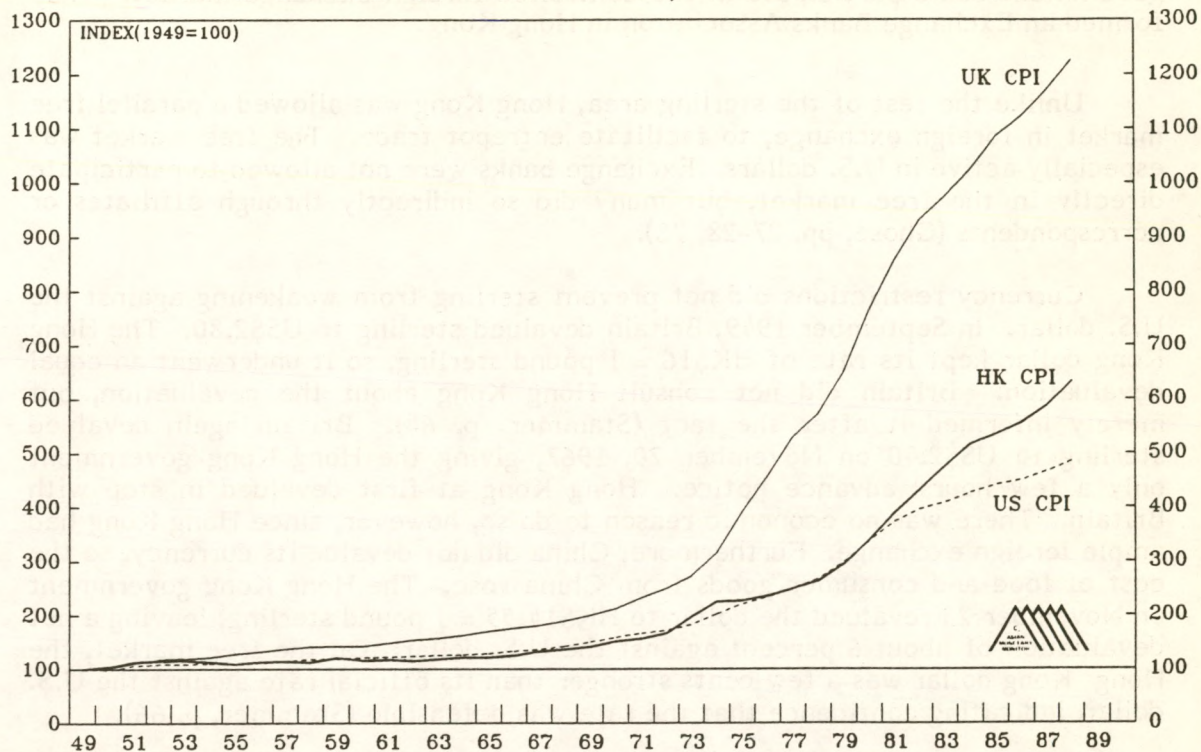
Upon returning to Hong Kong in September 1945, the British restored the Hong Kong dollar as legal tender and allowed military yen to be converted into dollars at 100 yen = \$1, up to a limit of 500 yen. After some discussion over how to handle the duress notes, the government decided to honour them in April 1946 (Ordinance No. 13). The Exchange Fund did not possess enough assets for a 100 percent reserve against legal notes plus duress notes. To avoid causing alarm to the public, it stopped publishing its accounts, and has never resumed. The banks paid the Exchange Fund 1 million pounds sterling (\$16 million) to increase its reserves, and it gradually made up the rest of the deficit from interest on assets. In 1953, the Exchange Fund announced that the reserve had reached 100 percent (Ghose, p. 24).

6. The convertible sterling exchange standard, 1947-1972

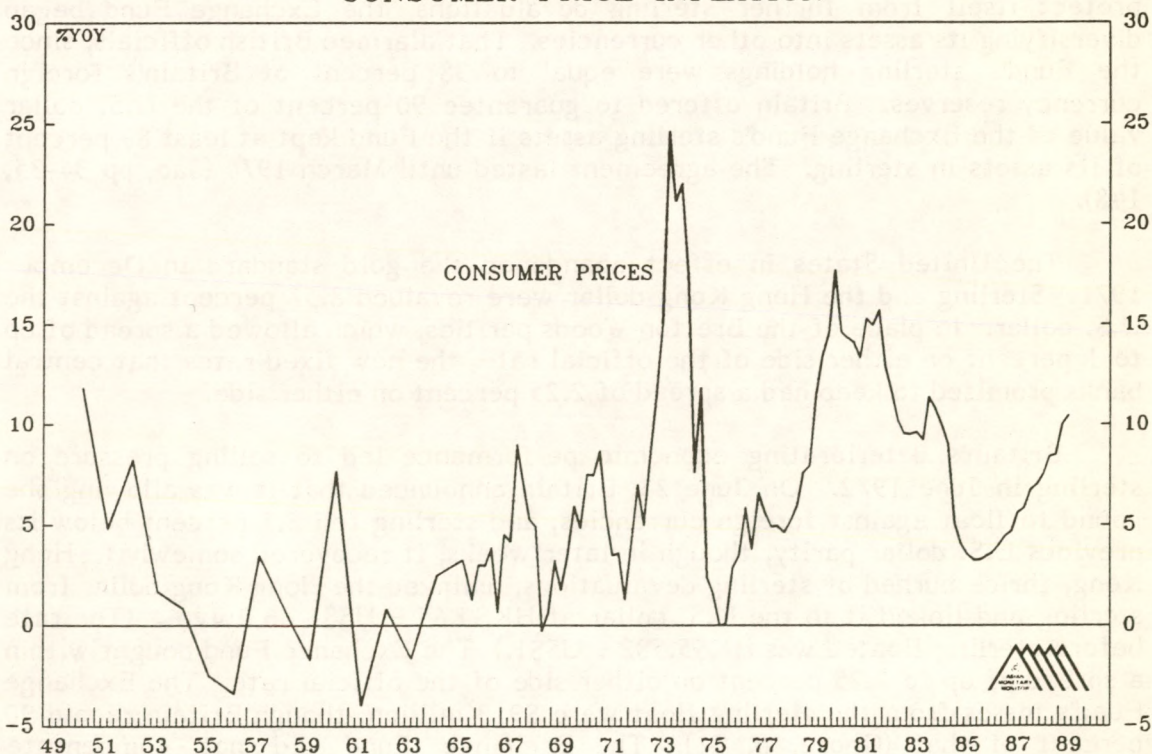
Britain restored convertibility of the pound sterling in 1947. Under the Bretton Woods system, sterling initially had a value of US\$4.03, compared with its old gold standard value of US\$4.80. The Hong Kong dollar maintained its prewar rate of \$16 per pound sterling. The Bretton Woods system permitted fluctuations of up to 1 percent around this value. The U.S. dollar was convertible into gold at \$35 per ounce, though only for central banks, not for individual non-governmental holders of U.S. dollars.

Sterling was a weak currency. To prop it up, Britain continued foreign exchange restrictions that it had enacted at the start of World War II. Complex rules governed foreign exchange transactions within the 'sterling area' (which included most Commonwealth countries and Hong Kong), and between the

HONG KONG: CHART 2
PRICE LEVELS IN HONG KONG, U.K. AND THE U.S.A.



HONG KONG: CHART 3
CONSUMER PRICE INFLATION



sterling area and countries outside it. Only certain banks authorised by the government could participate in the controlled foreign exchange market. They formed an Exchange Banks Association in Hong Kong.

Unlike the rest of the sterling area, Hong Kong was allowed a parallel free market in foreign exchange, to facilitate entrepot trade. The free market was especially active in U.S. dollars. Exchange banks were not allowed to participate directly in the free market, but many did so indirectly through affiliates or correspondents (Ghose, pp. 27-28, 78).

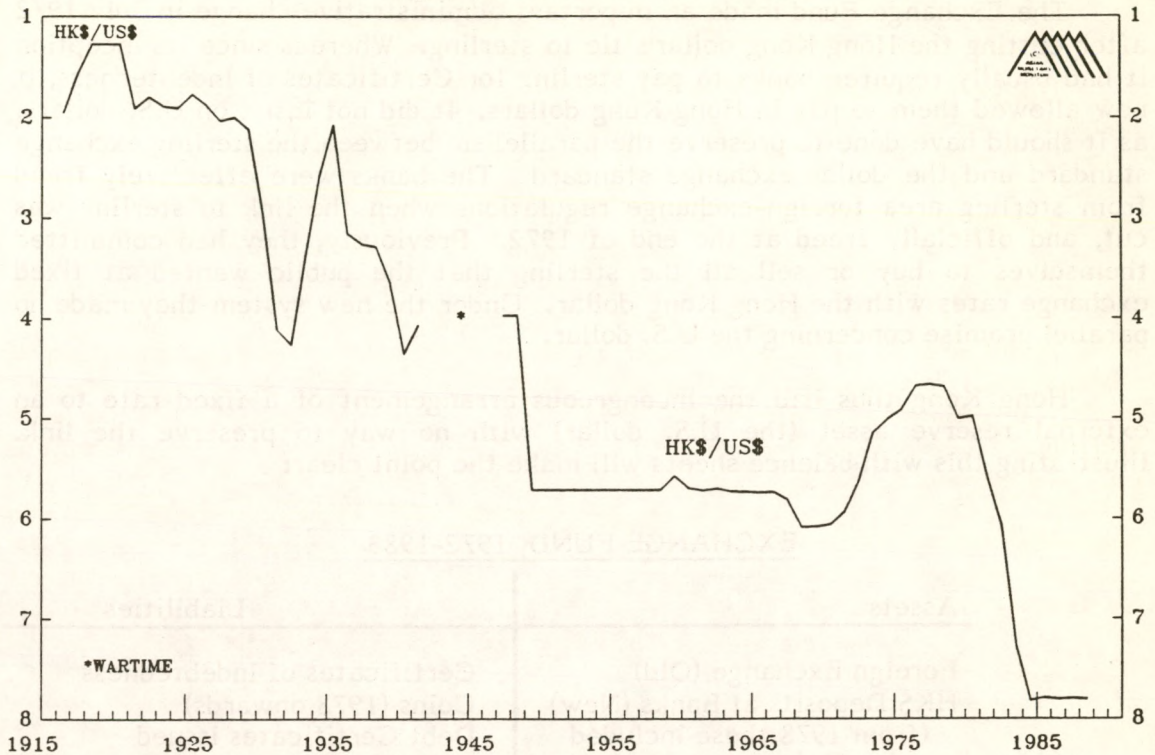
Currency restrictions did not prevent sterling from weakening against the U.S. dollar. In September 1949, Britain devalued sterling to US\$2.80. The Hong Kong dollar kept its rate of HK\$16 = 1 pound sterling, so it underwent an equal devaluation. Britain did not consult Hong Kong about the devaluation, but merely informed it after the fact (Stammer, p. 64). Britain again devalued sterling to US\$2.40 on November 20, 1967, giving the Hong Kong government only a few hours' advance notice. Hong Kong at first devalued in step with Britain. There was no economic reason to do so, however, since Hong Kong had ample foreign exchange. Furthermore, China did not devalue its currency, so the cost of food and consumer goods from China rose. The Hong Kong government on November 23 revalued the dollar to HK\$14.55 = 1 pound sterling, leaving a net devaluation of about 6 percent against the U.S. dollar. On the free market, the Hong Kong dollar was a few cents stronger than its official rate against the U.S. dollar, indicating confidence that the rate was defensible (Stammer, p. 66).

The Exchange Fund decided to compensate local banks for losses the devaluation had caused them by meeting the banks' estimated \$140 million loss and its own undisclosed loss from its accumulated surplus (Stammer, p. 65). To protect itself from further sterling devaluations, the Exchange Fund began diversifying its assets into other currencies. That alarmed British officials, since the Fund's sterling holdings were equal to 38 percent of Britain's foreign currency reserves. Britain offered to guarantee 90 percent of the U.S. dollar value of the Exchange Fund's sterling assets if the Fund kept at least 89 percent of its assets in sterling. The agreement lasted until March 1974 (Jao, pp 34-35, 148).

The United States in effect abandoned the gold standard in December 1971. Sterling and the Hong Kong dollar were revalued 8.57 percent against the U.S. dollar. In place of the Bretton Woods parities, which allowed a spread of up to 1 percent on either side of the official rate, the new fixed rates that central banks promised to keep had a spread of 2.25 percent on either side.

Britain's deteriorating economic performance led to selling pressure on sterling in June 1972. On June 23, Britain announced that it was allowing the pound to float against foreign currencies, and sterling fell 3.7 percent below its previous U.S. dollar parity, though in later weeks, it recovered somewhat. Hong Kong, thrice burned by sterling devaluations, unlinked the Hong Kong dollar from sterling and linked it to the U.S. dollar at HK\$5.65 = US\$1 on July 6. (The rate before sterling floated was HK\$5.582 = US\$1.) The Exchange Fund bought within a spread of up to 2.25 percent on either side of the official rate. The Exchange Fund's losses from the sterling float were \$913 million, though Britain repaid 90 percent of that (Ghose, p. 31). The Exchange Fund did not compensate

HONG KONG: CHART 4
HK\$/US\$ EXCHANGE RATE



banks for their sterling losses in 1972.

A few other developments in the years of the convertible sterling exchange standard deserve mention. Hong Kong enacted its first Banking Ordinance in 1948. It revised the ordinance in 1964 and 1967, after runs on some of the smaller banks in 1961, 1965 and 1967. The 1974 revision introduced specified liquid asset ratios. This required banks to hold at least 25 percent of assets in specified forms. Since average liquid asset ratios were normally about twice the legal minimum, the regulation seems to have had no real effect.

In 1956 and 1957, the Chartered Bank and the Hongkong Bank lost their small fiduciary note issues, which did not require Certificates of Indebtedness as cover (Stammer, p. 66).

In 1964, almost all local banks agreed to common deposit interest rates in the aftermath of a costly interest-rate war. Compliance was so high because non-signatories were threatened with exclusion from the clearing system, run by the Hongkong Bank, and with a boycott from signatories (Jao, pp. 241-2). In modified form, the agreement persists today, abetted by the legal powers granted to the Hong Kong Association of Banks to cartellise the industry, and by the government's control over the granting of new banking licenses.

7. The fixed rate U.S. dollar exchange standard, 1972-1974

The Exchange Fund made an important administrative change in July 1972 after cutting the Hong Kong dollar's tie to sterling. Whereas since its inception it had usually required banks to pay sterling for Certificates of Indebtedness, it now allowed them to pay in Hong Kong dollars. It did not insist on U.S. dollars, as it should have done to preserve the parallelism between the sterling exchange standard and the dollar exchange standard. The banks were effectively freed from sterling area foreign-exchange regulations when the link to sterling was cut, and officially freed at the end of 1972. Previously, they had committed themselves to buy or sell all the sterling that the public wanted at fixed exchange rates with the Hong Kong dollar. Under the new system they made no parallel promise concerning the U.S. dollar.

Hong Kong thus had the incongruous arrangement of a fixed rate to an external reserve asset (the U.S. dollar) with no way to preserve the link. Illustrating this with balance sheets will make the point clear:

EXCHANGE FUND, 1972-1983

Assets	Liabilities
Foreign Exchange (Old)	Certificates of Indebtedness
HK\$ Deposits at Banks (New)	Coins (1978 onwards)
(from 1978 these included	Debt Certificates Issued
balances of HK Government)	to Government (1978 onwards)

BANKS, 1972-1983

Assets	Liabilities
Certificates of Indebtedness	Notes
Loans	Private Sector Deposits
Foreign Exchange	Exchange Fund Deposits
	Equity

Linking the Hong Kong dollar to the U.S. dollar rather than to sterling reduced exchange rate risk for trade and investment with countries that, like the U.S., had not floated their currencies. However, there was still the danger that the U.S. dollar might be devalued or floated. In February 1973, the U.S. devalued its dollar 10 percent. The Hong Kong dollar was revalued to offset the U.S. devaluation, establishing a new rate of HK\$5.085 = US\$1. By mid-March, all major currencies were floating against the U.S. dollar. That the Hong Kong dollar did not have to float before the U.S. dollar is perhaps because the two note-issuing banks had a strong streak of public-spiritedness that disapproved of exploiting the new system simply because the possibility was there.

Sterling assets in the Exchange Fund fell from 99 percent of the total in 1967 to 70 percent in 1974 to 15 percent by the end of 1977 (Ghose, p. 32). U.S. dollar assets came to dominate the Exchange Fund's portfolio, even though the U.S. dollar proved to be little more stable in real terms than sterling.

8. The free issue standard, 1974-1983

On November 26, 1974, the Hong Kong government announced that it would no longer maintain a fixed rate link to the U.S. dollar. With that decision, the colony's monetary system entered uncharted waters. From the beginning, the dollar had always had a fixed rate link to silver or a foreign currency, except during Japanese occupation.

The changes that the Exchange Fund had made in July 1972 now began to have full effect. The result was that Hong Kong suffered a higher inflation than at any time since World War II. From 1974 to 1983, the consumer price index in Hong Kong increased about 128 percent, compared with 102 percent in the United States, 209 percent in Britain, and 95 percent in Japan.

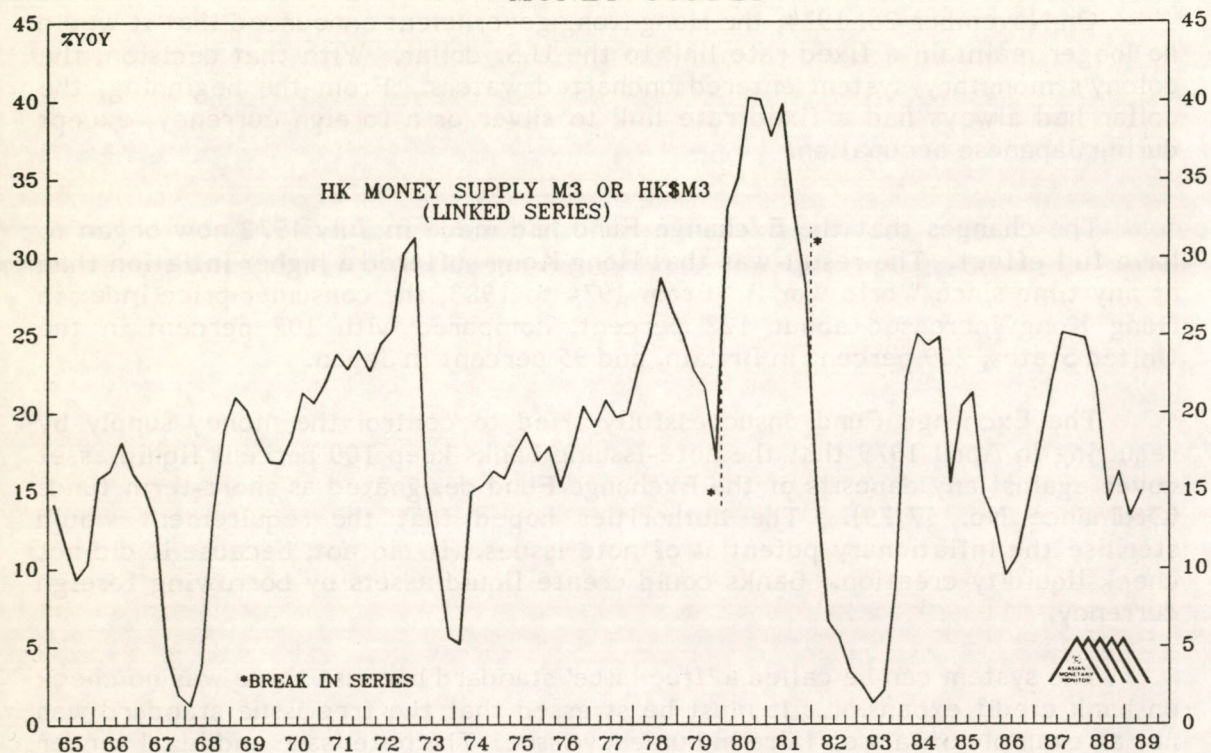
The Exchange Fund unsuccessfully tried to control the money supply by requiring in April 1979 that the note-issuing banks keep 100 percent liquid asset cover against any deposits of the Exchange Fund designated as short-term funds (Ordinance No. 17/79). The authorities hoped that the requirement would sterilise the inflationary potential of note issues. It did not, because it did not check liquidity creation. Banks could create liquid assets by borrowing foreign currency.

The system can be called a 'free issue' standard because there was no check on bank credit expansion. It must be stressed that the free issue standard was not an example of laissez faire in currency issue. The note issue and legal tender laws prevented people from switching to less inflationary currencies when Hong Kong's inflation became severe. The free issue standard was the worst of two worlds: it lacked the discipline of unfettered competition, such as had existed from 1845 to 1895, but because of its peculiar organisation, it did not offer the government any way to control it in orthodox central banking fashion either.

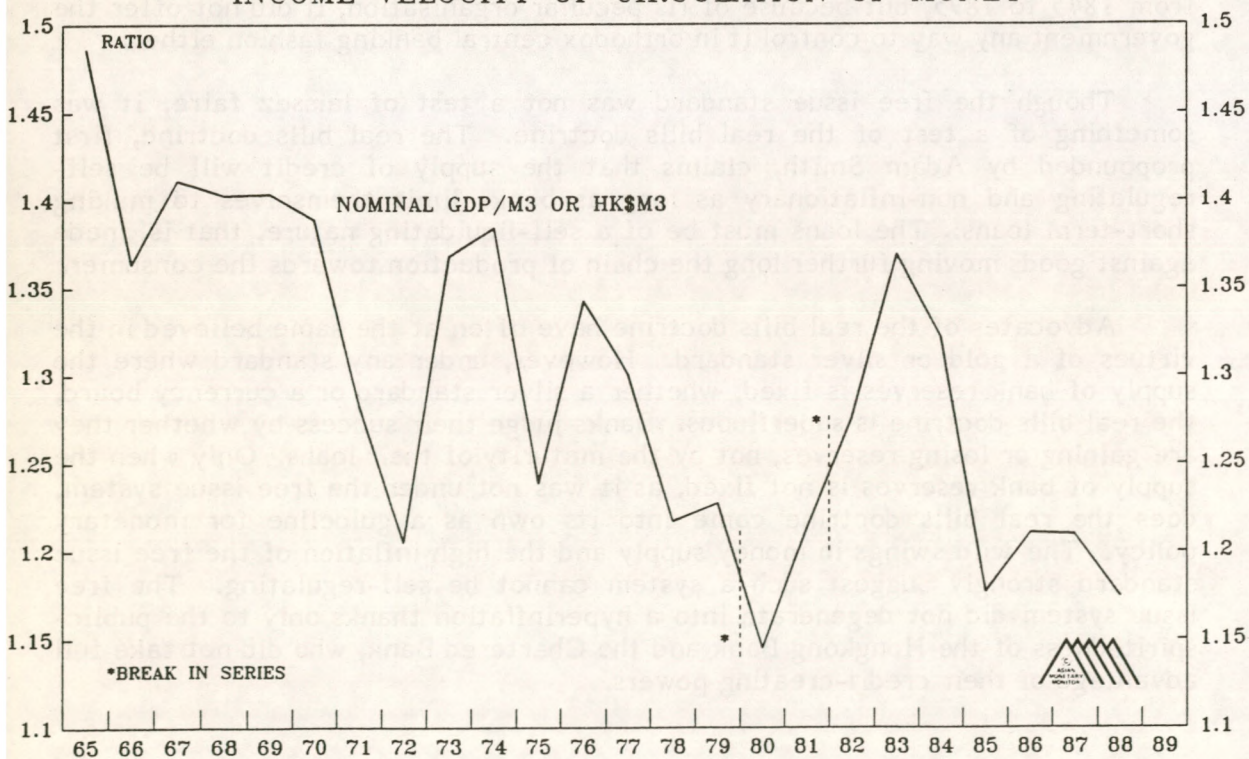
Though the free issue standard was not a test of laissez faire, it was something of a test of the real bills doctrine. The real bills doctrine, first propounded by Adam Smith, claims that the supply of credit will be self-regulating and non-inflationary as long as banks limit themselves to making short-term loans. The loans must be of a self-liquidating nature, that is, made against goods moving further along the chain of production towards the consumer.

Advocates of the real bills doctrine have often at the same time believed in the virtues of a gold or silver standard. However, under any standard where the supply of bank reserves is fixed, whether a silver standard or a currency board, the real bills doctrine is superfluous. Banks judge their success by whether they are gaining or losing reserves, not by the maturity of their loans. Only when the supply of bank reserves is not fixed, as it was not under the free issue system, does the real bills doctrine come into its own as a guideline for monetary policy. The wild swings in money supply and the high inflation of the free issue standard strongly suggest such a system cannot be self-regulating. The free issue system did not degenerate into a hyperinflation thanks only to the public-spiritedness of the Hongkong Bank and the Chartered Bank, who did not take full advantage of their credit-creating powers.

HONG KONG: CHART 5
MONEY SUPPLY



HONG KONG: CHART 6
INCOME VELOCITY OF CIRCULATION OF MONEY



9. The fiat U.S. dollar exchange standard mark I, 1983-1988

The free issue standard seemed to work fairly well for a number of years. Despite erratic monetary growth, which accentuated business cycles, Hong Kong's economy grew rapidly and the Hong Kong dollar kept a trade-weighted value roughly the same as it had in the early 1970s.

However, the free issue standard proved unable to withstand the erosion of confidence in the Hong Kong dollar that occurred after Sino-British talks on the future of Hong Kong began in 1982. The Hong Kong dollar fell steadily against major currencies, going from under HK\$6 per U.S. dollar through the \$7 mark. In mid-August 1983, a top Chinese official stated that China might take Hong Kong back even before 1997. The Hong Kong dollar dropped below \$8 per U.S. dollar on September 17 to a low of \$9.55 on September 24.

Many shops refused to accept Hong Kong dollars and quoted prices in U.S. dollars for imported items. Panic buying of rice, vegetable oil, and other essential household items set in. On Sunday, September 25, top government officials, representatives from the two note-issuing banks, and the publisher of the AMM met to discuss ways of resolving the crisis. Following the meeting, the government announced that it was considering measures to stabilise the currency, and that convertibility would be an important part of any new scheme. It also separately warned that demanding foreign currency for local transactions was illegal under the 1913 ordinance mentioned in section 3 above.

The next day, the Hong Kong Association of Banks announced a 3 percent rise in deposit interest rates. Savings deposit rates went from 7 percent to 10 percent. Over the following weeks, the Hong Kong dollar pulled back from its low of September 24, but remained at more than \$8 per U.S. dollar. The high interest rates that the Hong Kong Association of Banks had announced did not by themselves raise the Hong Kong dollar's exchange value to pre-crisis levels.

On October 15, the government announced its stabilisation plan. The plan was a modified version of a proposal made in the September-October 1983 issue of AMM. In essence, it was a currency board system. The government fixed the Hong Kong dollar at HK\$7.80 = US\$1. The two note-issuing banks were required to pay U.S. dollars at that rate to receive Certificates of Indebtedness from the Exchange Fund. Conversely, the Exchange Fund would pay them U.S. dollars at the same rate when they diminished their note issue and redeemed Certificates of Indebtedness. The note-issuing banks agreed to offer the same rate to other banks that wanted to buy or sell notes. Hence the Hang Seng Bank, for example, had to give the Hongkong Bank US\$100 for every \$780 of Hongkong Bank notes that it bought. (See 'Hong Kong: The Stabilisation of the Hong Kong Dollar, AMM, November-December 1983.) To remove one disincentive to holding Hong Kong dollars, the government abolished interest taxes on Hong Kong dollar deposits.

The U.S. dollar rate that the banks offered to the public was a band around the official rate. The band's limits were determined by supply and demand for Hong Kong dollars. By October 20, the rate to the public had gone slightly below \$7.80. Arbitrage generally kept the rates offered to the public within about 4 cents on either side of \$7.80, or about ½ percent. (Exceptions occurred in July

1984, when rumours of difficulties in the Sino-British talks over Hong Kong's future pushed the exchange rate as low as HK\$7.94 = US\$1, and on a few occasions when there was speculation that the Hong Kong dollar would be revalued against a weak U.S. dollar.) Interbank overnight interest rates, after briefly going as high as 32 percent immediately after the new system was announced, settled down to levels roughly equivalent to U.S. dollar rates.

Since 1983, the Hong Kong dollar has been in effect a denomination of the U.S. dollar. Creating new Hong Kong dollar liabilities (assuming that note demand grows in step with demand to hold deposits) depends on acquiring U.S. dollars, just as under the sterling exchange standard it depended on acquiring sterling. The finite supply of U.S. dollars imposes a brake on credit expansion that did not exist under the free issue standard.

Whether the U.S. dollar is the best currency to make the link to may be debated, but it has advantages. Since the United States is Hong Kong's largest export market, the link greatly reduces exchange rate risk for many exporters. The link gives Hong Kong easy access to the world's largest financial market. In foreign exchange, for instance, the Hong Kong dollar can 'piggyback' on the U.S. dollar, which is most widely traded currency. Finally, the U.S. dollar has had a much lower inflation rate in the 1980s than Hong Kong had under the floating rate standard, and Hong Kong has benefited from lower inflation in recent years.

The great disadvantage of the U.S. dollar as the reserve medium of Hong Kong's monetary standard is that the U.S. dollar may prove to be no better than sterling was as a store of value. But other possibilities - linking the Hong Kong dollar to the yen, to a basket of currencies, or even to gold - have their own disadvantages.

10. The fiat U.S. dollar exchange standard mark II, 1988-present

On July 15, 1988, the Hong Kong government announced potentially far-reaching alterations in the Exchange Fund's relations with the banking system. The Fund now has powers that make it less like a passive currency board and more like a central bank, with tools to actively influence the exchange rate.

The Exchange Fund created a non-interest-bearing account for the Hongkong Bank that is a liability of the Exchange Fund. Ever since 1935, the Exchange Fund had been a customer of the Hongkong Bank and others where it held deposits. That contrasts with typical central banking practice, where commercial banks hold deposits at the central bank. The Exchange Fund requires the Hongkong Bank, which manages the clearinghouse, to keep a certain sum in the new account that is about equal to the net clearing balance of the rest of the banking system. That deprives the Hongkong Bank of its previous quasi-central banking power of expanding credits to other banks without increasing the size of its own balances at the Exchange Fund. The Hongkong Bank also loses the interest-free use of other banks' clearinghouse deposits, though it retains some advantage from running the clearinghouse because it does not have to deposit an amount equal to its own clearing balance in the new Exchange Fund account.

The new arrangement gives the Exchange Fund the power to conduct open market operations. For instance, the Exchange Fund may purchase foreign

currency. The seller of the currency will deposit his check from the Exchange Fund with a bank - for simplicity's sake, assume it is the Hongkong Bank itself. The balance in the Hongkong Bank's account with the Exchange Fund increases, enabling the bank to purchase new Certificates of Indebtedness and expand its note issue, or to expand its loans and suffer greater clearing losses than before. Hence the money supply increases just as in orthodox central bank practice. Conversely, the Exchange Fund can make the money supply contract by, say, selling foreign currency that it holds.

The July 1988 measures also made it possible for the government to influence the money supply by transferring Hong Kong government deposits at the Exchange Fund into or out of the banking system. (Since 1978, the Exchange Fund had held accumulated government budget surpluses as an asset against Debt Certificates issued to the Treasury, but it had never held government deposits as a liability.) The Exchange Fund is 'outside' the banking system, so if the government transfers money from a bank to the Exchange Fund, the banking system loses reserves and must contract loans. Conversely, a transfer from the Exchange Fund to a bank increases reserves and enables a bank to expand loans.

EXCHANGE FUND, 1988-PRESENT

Assets	Liabilities
Foreign Exchange	Certificates of Indebtedness
HK\$ Deposits at Banks (including HK Government Balances)	Coins
	Debt Certificates
	Deposit Account of HK Bank (new)

BANKS, 1988-PRESENT

Assets	Liabilities
Certificates of Indebtedness	Notes
Hongkong Bank HK\$ Deposit at Exchange Fund (new)	Private Sector Deposits
Loans	Exchange Fund Deposits
Foreign Exchange	Equity

Ultimately, the fixed U.S. dollar exchange rate limits the extent of open-market operations. The Exchange Fund cannot make the money supply expand too fast, otherwise the Hong Kong price level will rise above the U.S. price level and people will convert Hong Kong dollars into U.S. dollars. Assuming that the demand for Hong Kong dollar bank notes and clearing balances falls in step with the rise in the demand for U.S. dollars, the Exchange Fund will have to pay out U.S. dollars. In the hypothetical extreme case of complete conversion of Hong Kong dollars into U.S. dollars, the Exchange Fund would cease to have any effect on the Hong Kong money supply.

In the short term, though, the Exchange Fund and the government can now

influence the exchange rate and interest rates. The Exchange Fund has on several occasions intervened in the market (see the May-June 1989 AMM). It did so after the June 4 Beijing massacre to inject HK\$194 million into the system, which brought down interbank loan rates and helped the Bank of China, the principal interbank borrower at the time. So far, the Exchange Fund's actions have tended to make the variability of the U.S. dollar exchange rate offered to the public lower than before, but it could just as well use its new tools to increase the variability, if it wished. The Exchange Fund has just announced that by the end of 1989, it intends to issue between \$3 billion and \$4 billion of 13-week monetary bills. The bills will enable the Exchange Fund to conduct open-market operations in the domestic money market precisely as central banks elsewhere do.

Defects of the existing standard in the light of historical experience

Comparing Hong Kong's present monetary standard to the arrangements it has had through its history, several defects in the present standard are apparent:

(1) The exchange rate link to the U.S. dollar is not statutorily fixed. The government may change the rate at its pleasure. Hence there is a risk of exchange loss. The remedy is to fix the rate statutorily, as was the case up until 1935, when Hong Kong was on the silver standard.

(2) There is the potential of a demand for bank notes causing a liquidity crunch. Under a sterling exchange or dollar exchange system, any demand for bank notes reduces banks' foreign currency holdings, putting pressure on them to contract loans. Hong Kong experienced this phenomenon most acutely in 1967, when bank failures sparked an extraordinary demand for notes. Wisely, the Exchange Fund let the note-issuing banks buy Certificates of Indebtedness with Hong Kong dollars rather than sterling, because it thought that bank notes merely held in people's mattresses would not threaten the exchange rate. But if bank note issue were unrestricted, as it was from 1845 to 1895, the problem would not arise at all. There is no necessary connection between demand for bank notes and demand to convert into foreign currency.

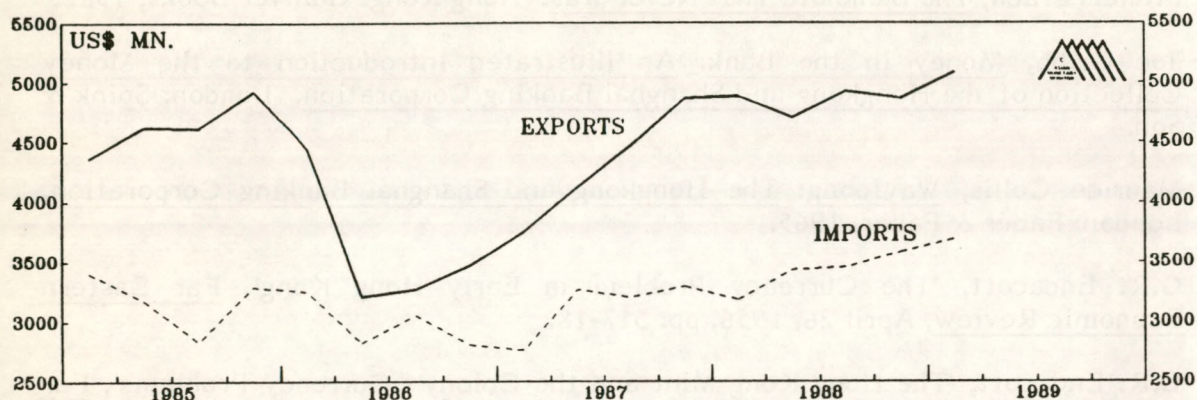
(3) The link to the U.S. dollar is not as tight as it could be. The public cannot exchange at the official rate, but must instead suffer slight transactions costs. The link could be tightened by requiring banks to exchange with the public at HK\$7.80 = US\$1, or some narrow spread about that rate. Such an arrangement would be similar the practice under the silver standard before bank note issues were restricted. The link could also be tightened by allowing other banks besides the note-issuing bank direct access to the Exchange Fund.

(4) Finally, the U.S. dollar may not continue to be the best 'base' for the Hong Kong dollar. If the remaining obstacles to foreign currency use, such as legal tender laws, were abolished, it would leave the door open to other, potentially superior bases for the Hong Kong dollar. Which base finally became the most widely accepted could be left to the marketplace. (On all these matters, see the symposium 'Hong Kong's Monetary System' in the January-February 1988 AMM.)

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INDONESIA: AN EASING OF MONETARY POLICY HAS ACCOMPANIED FINANCIAL DEREGULATION

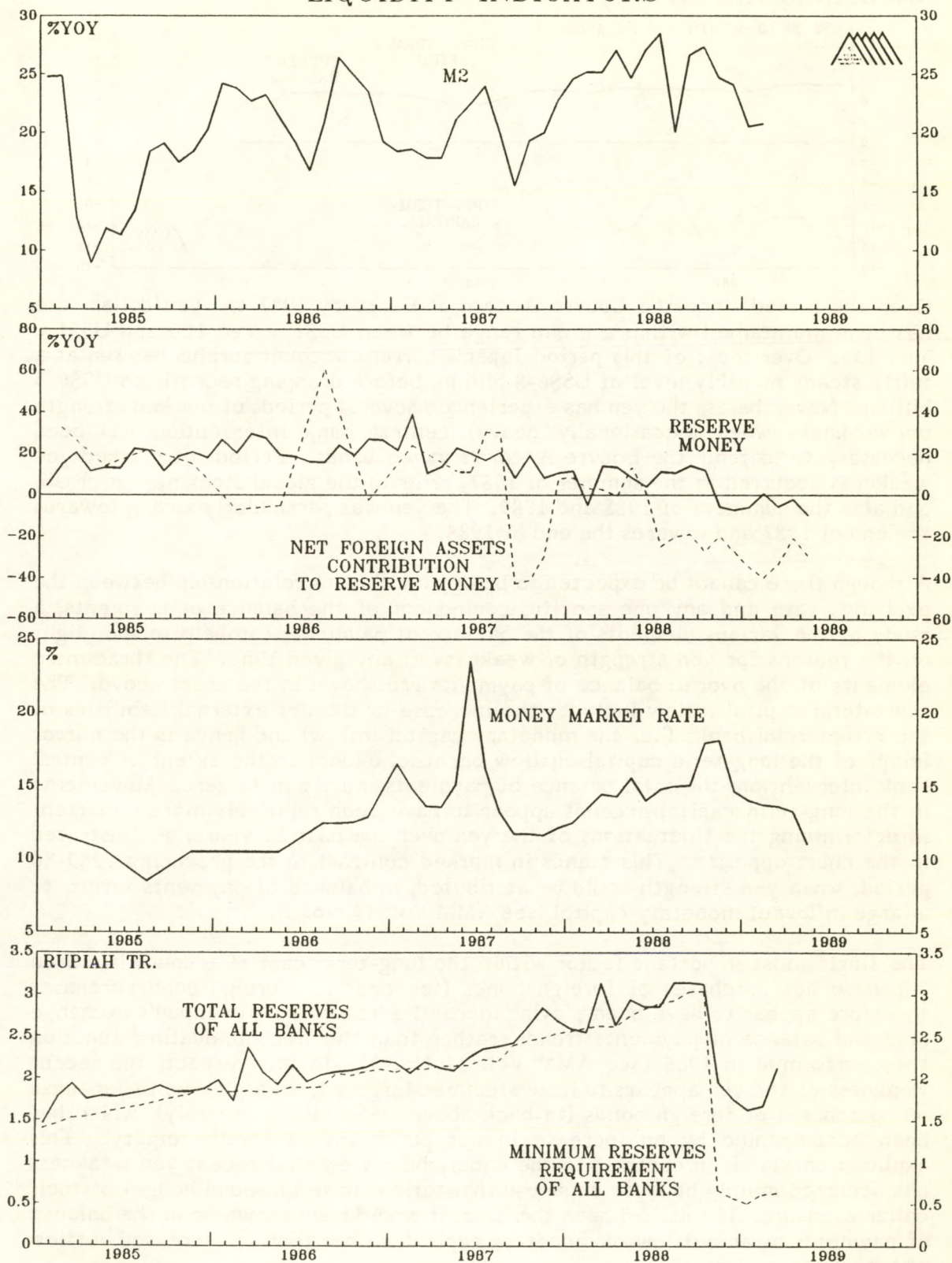


The Indonesian financial system has been significantly deregulated since 1983. In the most recent major liberalisation, in October last year, the aspect of the liberalisation package which attracted most attention was the introduction of much greater competition into the banking system. State enterprises were permitted to place up to 50% of their deposits outside the state banks, in private or foreign banks, and licensing regulations were relaxed to permit the establishment of new domestic banks and foreign bank branches.

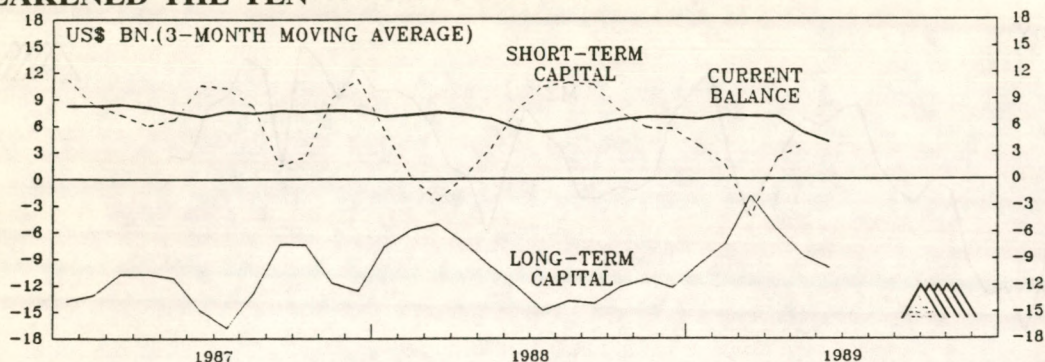
However, of more immediate monetary significance have been measures leading to a sharp easing in monetary conditions, most important of which has been a sharp reduction in banks' reserve requirements. Prior to October 1988 banks were required to maintain reserves (vault cash plus deposits with Bank Indonesia) equivalent to 15% of Rupiah current liabilities, where 'current liabilities' were calculated as a weighted sum of the various classes of Rupiah deposit. At least one third (i.e. 5% of current liabilities) of reserves had to be held in the form of deposits with Bank Indonesia. In addition there were separate liquidity and reserve requirements against foreign exchange liabilities and rupiah liabilities to non-residents. With the October deregulation package the minimum reserves requirement was cut to 2% of all deposits, with the requirement to maintain part of reserves at Bank Indonesia, and also the separate requirements against foreign liabilities, abolished. The change in reserve requirements freed up Rupiah 2.4 trillion of reserves, equivalent to a roughly 25% expansion of the monetary base, with the result that money market rates dropped sharply (see chart).

Additionally, the authorities have taken a number of measures which have the effect of encouraging greater foreign borrowing by banks. These have included (from October) an extension of the time period (from six months to three years) over which the central bank will guarantee forward cover for banks' foreign borrowings, and (from May) the removal of ceilings on offshore borrowing and the introduction of effective limits on banks' holdings of net foreign assets. Together with the abolition of separate reserve requirements against foreign liabilities, these measures have altered the thrust of regulations from one which discouraged monetary capital inflows to one which now discourages outflows. If this leads to a recovery in Bank Indonesia's net foreign assets it should be a further factor stimulating a higher rate of money growth over the next year.

INDONESIA LIQUIDITY INDICATORS



JAPAN: RISING LONG-TERM CAPITAL OUTFLOWS HAVE WEAKENED THE YEN

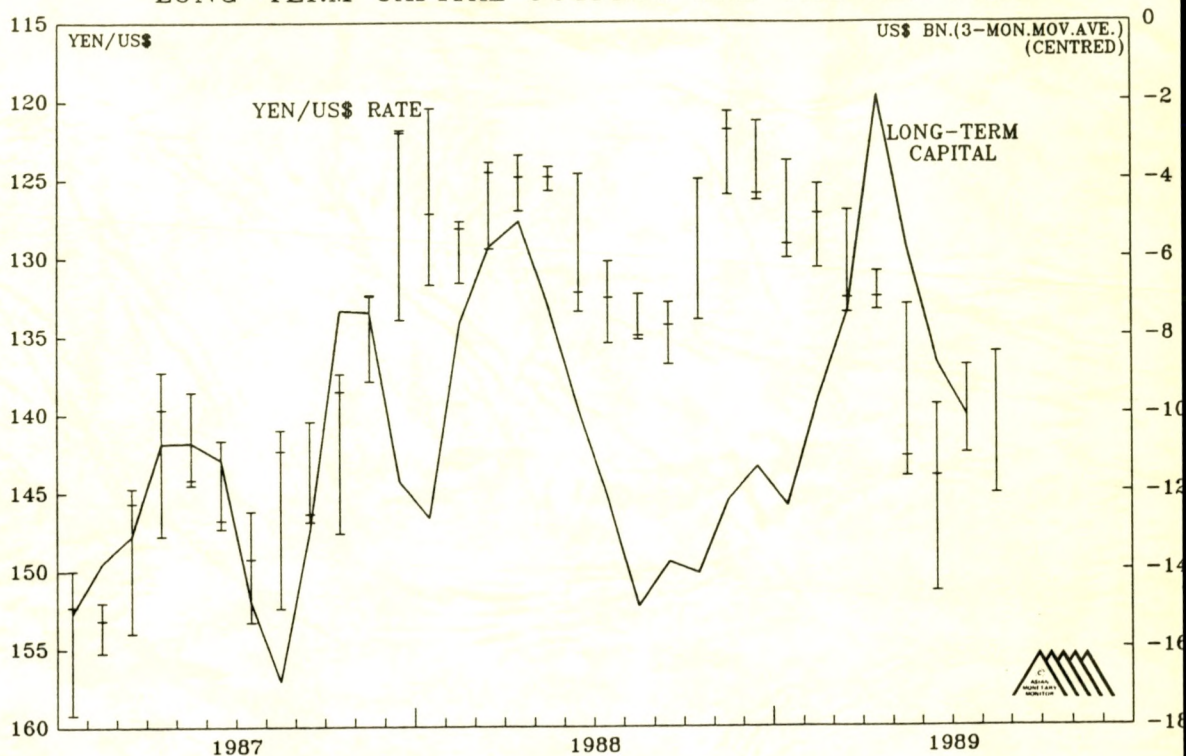


Over the period since the Louvre Accord of February 1987 the yen/dollar rate has been maintained within a broad range between US\$1 = Yen 120 and US\$1 = Yen 155. Over most of this period Japan's current account surplus has run at a fairly steady monthly level of US\$6-8 billion, before dropping recently to US\$4-5 billion. Nevertheless the yen has experienced several periods of marked strength or weakness when (occasionally heavy) central bank intervention has been necessary to 'defend' the Louvre Accord's vague bands. Periods of marked yen weakness occurred in the summer of 1987, prior to the global stockmarket crash, and also the summers of 1988 and 1989. The yen was particularly strong towards the end of 1987 and towards the end of 1988.

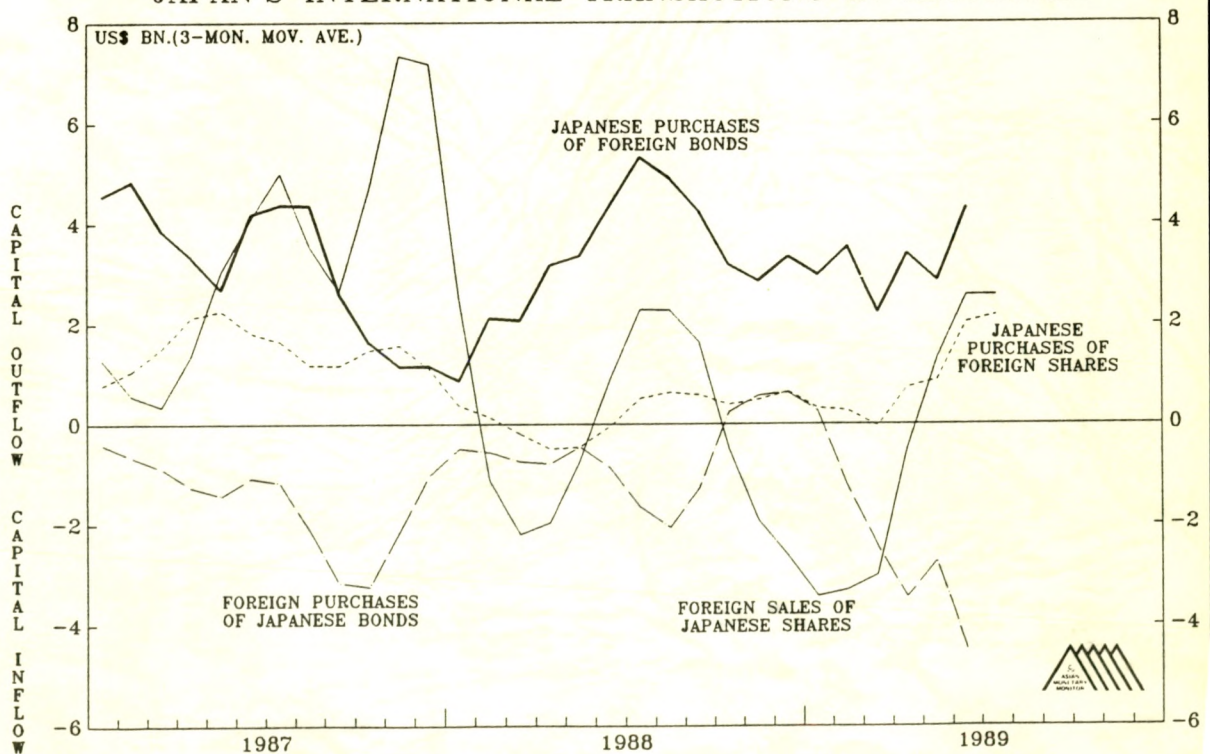
Although there cannot be expected to be any continuous relationship between the exchange rate and any one specific component of the balance of payments, a study of the various elements of the balance of payments can help to shed light on the reasons for yen strength or weakness at any given time. The three main elements of the overall balance of payments are shown in the chart above. The short-term capital inflow includes the increase in the net external liabilities of the commercial banks (i.e. the monetary capital inflow) and hence is the mirror image of the long-term capital outflow because, except to the extent of central bank intervention, the total balance of payments must sum to zero. Movements in the long-term capital account appear to have been relatively more important in determining the fluctuations of the yen over the past 2½ years, as illustrated in the chart opposite. This stands in marked contrast to the preceding 1985-86 period, when yen strength could be attributed, in balance of payments terms, to a large inflow of monetary capital (see AMM Vol. 11 No. 3).

The single most important factor within the long-term capital account has been Japanese net purchases of foreign bonds (see chart). Foreign bond purchases therefore appear to have been playing more of a 'causal' role in Japan's exchange rate and balance of payments trends, rather than the 'accommodating' function they performed in 1986 (See AMM Vol. 11 No. 3). In this respect, the recent weakness of the yen appears to have stemmed largely from a pick-up in Japanese net purchases of foreign bonds (to back above US\$4 billion monthly), which has been accompanied by an increase in net purchases of foreign equity. This explanation stands in contrast to the widely held view that recent yen weakness has occurred mainly because Japanese institutions have unwound hedges of their dollar exposure. If this had been the case, it would have shown up in the balance of payments as an outflow of monetary capital, rather than an increased outflow of long-term capital.

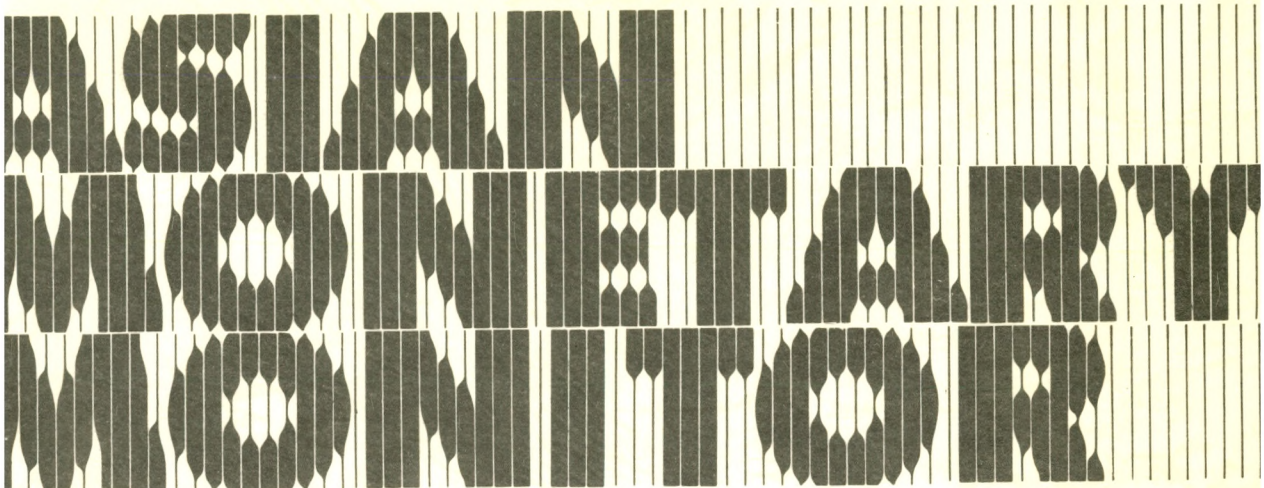
LONG-TERM CAPITAL OUTFLOW AND THE YEN RATE



JAPAN'S INTERNATIONAL TRANSACTIONS IN SECURITIES







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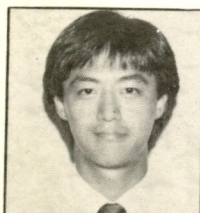
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REGIONAL SURVEY

FOREIGN DIRECT INVESTMENT AND TRADE: JAPAN, ASEAN AND THE NICs.

Trade and foreign investment are closely interlinked. A great deal of attention has been paid to Japanese foreign direct investment (FDI) in the United States, an investment flow partially caused by the balance of trade deficit of the US. However, FDI is not only caused by trade imbalances. It also responds to, and causes changes in trade relations amongst countries.

An important development in this area has been the growing interdependence amongst the Association of Southeast Asian Nations (ASEAN) and Newly Industrialised Countries (NICs) on one hand and the role of Japan in these relationships on the other. A previous AMM survey (Vol. 13. No. 3) examined the growth of East Asian intraregional trade and investment. This study focuses on FDI in the region and the changing role of Japan.

Table 1 indicates the growth of the importance of the ASEAN 4 (Thailand, Malaysia, Indonesia and Philippines) and the NICs (Korea, Taiwan, Hong Kong and Singapore) in world trade.

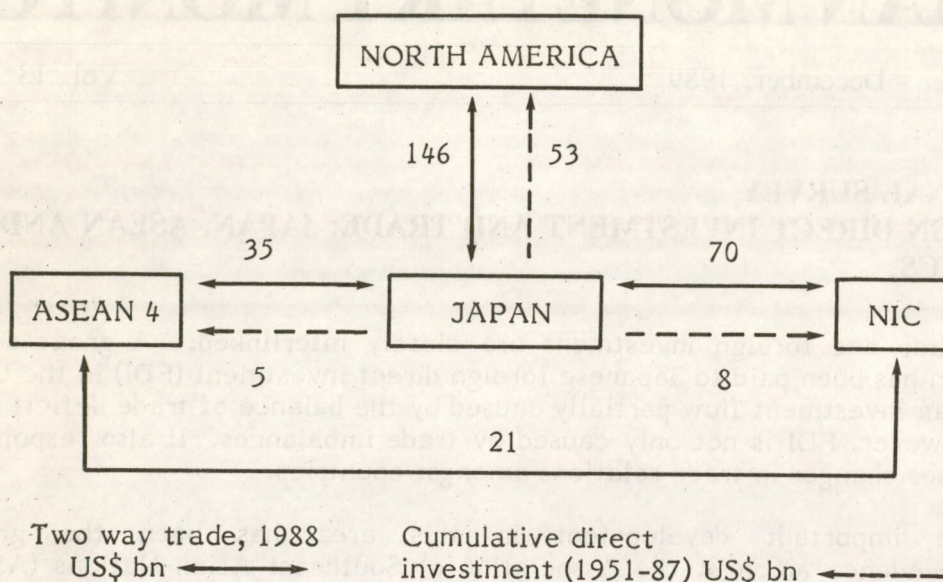
TABLE 1

Share of Exports and Imports of ASEAN and NIC in World Trade (%)

<u>ASEAN</u>	1970	1980	1985	1988
Exports	1.6	2.5	2.5	3.4
Imports	1.6	2.0	2.0	2.4
<u>NIC</u>	1970	1980	1985	1988
Exports	2.2	4.0	6.3	7.7
Imports	2.9	4.5	5.7	6.3

Diagram 1 also puts these shares in perspective with regard to trade and investment flows between Japan and countries in the region as well as with North America.

DIAGRAM 1



Trade between the ASEAN 4 and the NICs has grown by more than 60% between 1978 and 1988. This compares favourably with the 45% growth of trade between Japan and the ASEAN 4 over the same period, although it is still well below the 105% increase in the Japan-NICs trade. Table 2 shows the trade interdependence of these countries and Japan in 1988. For ease of reference the heavily outlined squares show intra-ASEAN and intra-NICs trade. The row figures indicate the destination of exports and the origins of imports as percentage of totals. So, for example, 17.1% of Malaysia's exports were sold to Japan and 4.9% to Korea, whilst 23.4% of imports to Malaysia were from Japan, 2.5% from Korea etc. The column figures indicate the relative importance of each country as a market for exports or source of imports. So, for example, Thailand accounts for 1.9% of all Japanese exports whilst it provides 1.4% of all imports into Japan. The dominance of Japan in these trade flows is self-evident. Japan in 1988 took, on average, 12.2% and 21% respectively of the exports of the NICs and ASEAN 4 and supplied 25% and 24% respectively of their imports. This is an aspect of a growing intraregional dependence which may partially diminish the role of the United States as the major customer for these countries (see AMM Vol. 13 No. 3).

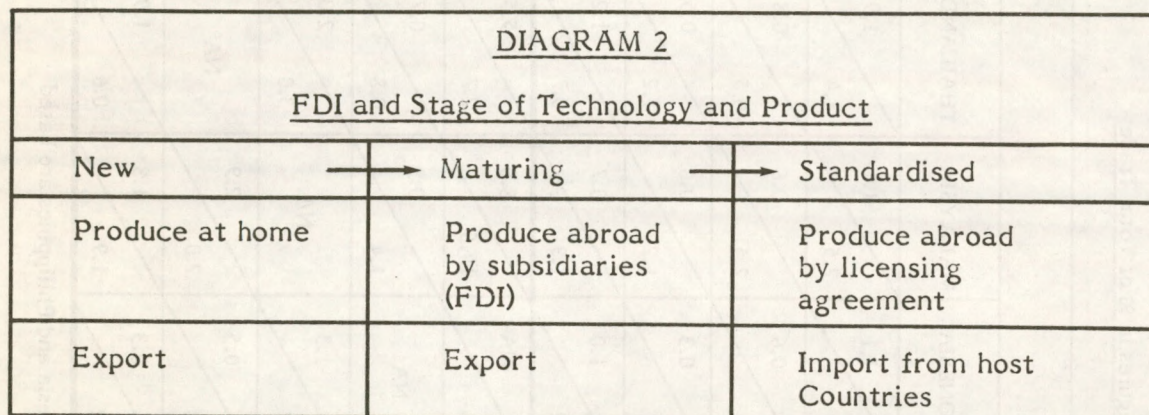
There are, however, different patterns emerging in the inter and intra ASEAN-NICs trade. In the six year period 1983-88 Taiwan's imports share from the other three NICs rose from 3.1% of total to 7.1% whilst its exports to them also increased from 10.2% to 13.4%. The equivalent figures for Korea for the same period were 3.4% to 4% and 6.1% to 9.5%. In the case of ASEAN countries the trading links between Singapore and Malaysia are well established, although over 1983-88 the share of intra-ASEAN imports and exports for both Thailand and Indonesia declined, whilst those between Thailand and the NICs tended to rise. The PRC has not been included in the figures of Table 2 as it is relatively unimportant as an export market for these countries, with the exception of Hong Kong, and therefore constitutes a separate case.

TABLE 2 Trade Interdependence, Japan, ASEAN, NICs, 1988. Figures in % of Total Trade

EXPORTS TO IMP. FROM		NIC																
		JAPAN	KOREA	HONGKONG	TAIWAN	SINGAPORE	INDONESIA	MALAYSIA	THAILAND	PHILIPPINES								
JAPAN		NA	6.3	5.8	1.1	4.4	4.6	5.4	1.2	3.1	5.0	1.1	2.5	1.1	1.4	1.9	1.0	0.6
KOREA		19.7	NA	NA	1.0	5.8	2.0	1.5	1.0	2.2	1.2	0.6	2.5	0.6	0.5	0.8	0.3	0.5
H.K.		18.6	5.2	0.5	NA	NA	8.8	1.5	3.7	2.3	0.7	0.3	1.2	0.6	1.2	0.5	0.4	0.7
TAIWAN		29.8	14.4	1.5	3.8	9.2	NA	NA	1.5	2.7	1.2	1.0	1.9	0.7	0.7	1.2	0.5	1.0
SING.		22.0	9.8	2.8	2.7	6.5	4.5	2.4	NA	NA	1.8	NA	14.6	8.0	2.7	5.5	0.6	0.9
INDO.		28.6	42.4	3.1	0.8	2.7	5.0	3.2	7.3	8.5	NA	NA	1.4	0.9	0.8	0.7	0.5	0.3
MAL.		23.4	17.1	2.5	2.3	3.5	4.5	2.9	13.9	19.2	1.7	1.3	NA	NA	3.0	2.0	0.8	1.4
THAI.		29.0	15.9	2.7	1.2	4.4	4.1	1.8	7.4	7.6	0.8	0.5	2.0	2.9	NA	NA	0.9	0.3
PHIL.		16.9	20.1	4.1	4.4	4.9	6.0	2.9	4.1	3.3	2.2	0.3	1.9	1.8	0.6	1.9	NA	NA

NB: Exports for Singapore and Hong Kong refer to domestic exports only. Figures for Indonesia and Philippines are based primarily on the first three quarters of 1988.

The flows of trade and of FDI are ultimately complementary although the reasons why firms invest abroad and the initial impact of that investment on trade can be quite complex. On a simple basis, the life cycle of a product creates opportunities for the investment-trade nexus. Diagram 2 shows a typical sequence of events which also partially reflects the approach of some Japanese firms to foreign investment.



A more sophisticated model will also take into account the firm specific advantages for FDI. These will include, primarily, technical know-how, managerial and marketing skills and patent ownership and trademarks. These advantages might be cheaper to exploit via FDI if there are high costs in making and enforcing contracts or ensuring patent and copyright compliance. This has been called the process of "internalisation" of these advantages to the firms concerned. Finally, and perhaps most importantly, there should be country-specific advantages such as low cost labour and skills, availability of natural resources, etc.

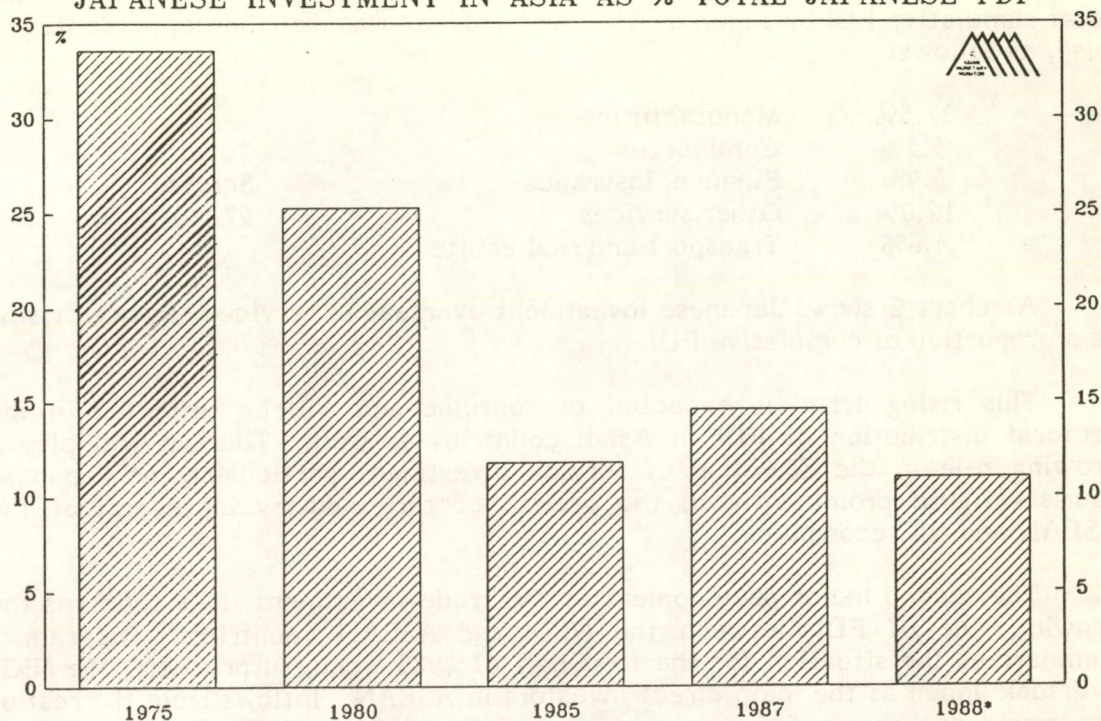
There are at present three factors at work which are both shaping and changing the Japan-ASEAN-NICs trade and investment flows. Firstly, Japanese FDI in Asia is not increasing as a proportion of total, but its regional and sectoral distribution is changing. Secondly, the developing intra and inter NICs-ASEAN trade and the rise of regionally based non-Japanese multinational enterprises is likely to lessen in relative terms the dominance of Japan. Finally, individual countries within ASEAN and the NICs have different experiences with the trade-investment links. A good example here is the very rapid and direct links which have developed between Hong Kong and the PRC and which are primarily FDI based.

Japanese annual FDI in Asia has fluctuated considerably as a percentage of total Japanese overseas investment, as shown in Chart 1. The rate of growth of Japanese FDI is also showing evidence of slowing down for both ASEAN and the NICs:

	1986	1987	1988 (first half)
NIC	113.2	73.3	32.4
ASEAN	-7.2	66.6	52.2

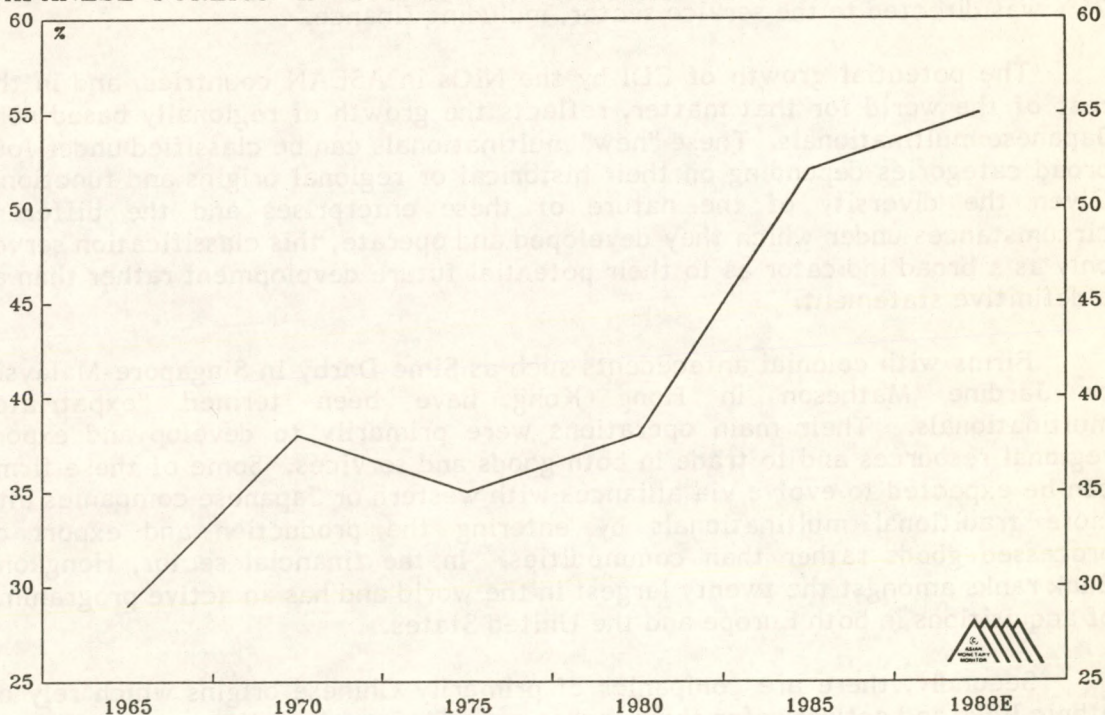
(Figures are percentage changes over previous year)

REGIONAL SURVEY: CHART 1
JAPANESE INVESTMENT IN ASIA AS % TOTAL JAPANESE FDI



* ESTIMATE BASED ON ASEAN AND NIC INVESTMENT ONLY, FIRST HALF OF 1988.

REGIONAL SURVEY: CHART 2
JAPANESE FOREIGN INVESTMENT IN SERVICES AS % TOTAL JAPANESE FDI



Furthermore the direction of investment is now moving towards the service rather than the manufacturing sectors. So, for example, at the end of 1987 the total cumulative FDI by Japan in Asia over 1951-87 was distributed, percentage wise, as follows:

37.5%	Manufacturing	
5.5%	Commerce	Total
5.4%	Finance, Insurance	Services
12.0%	Other services	27.5%
4.6%	Transport and real estate	

As chart 2 shows Japanese investment overseas in services has been rising as a proportion of cumulative FDI.

This rising trend is expected to continue and will be reflected in the sectoral distribution of FDI in Asian countries as well. Tourism will play a growing role in the direction of service investment particularly as Japanese tourists figure prominently in the growth of this industry in several of the ASEAN and NIC economies.

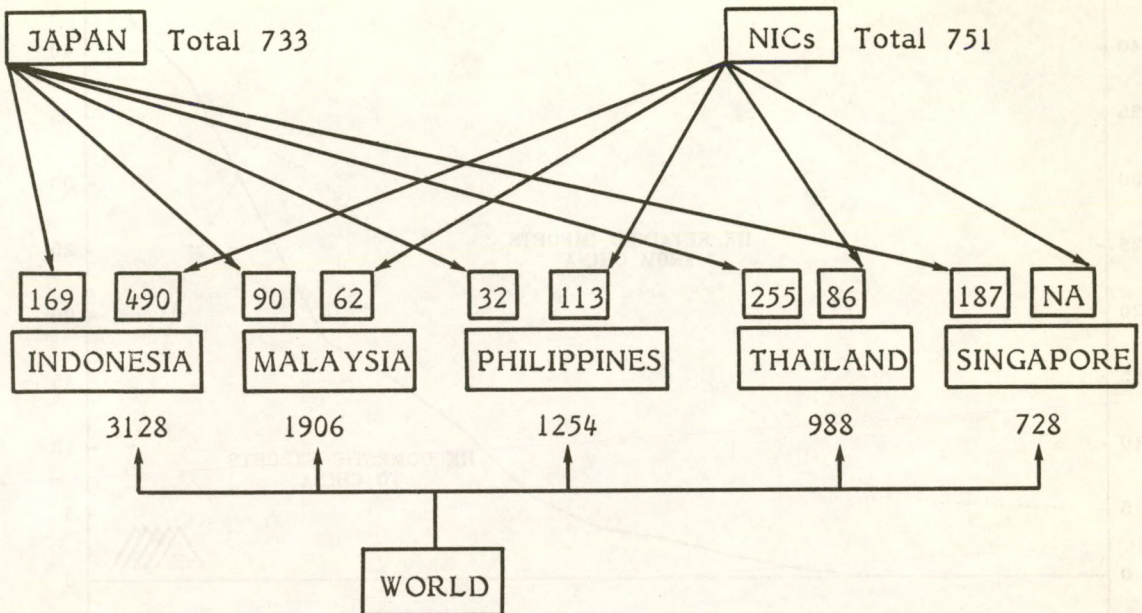
The second major development in the trade-investment links concerns the growing role of FDI between the NICs and ASEAN countries. Diagram 3 summarizes the situation for the first half of 1988 when, surprisingly, the NICs overtook Japan as the main direct investors in ASEAN. Inflows from the rest of the world are shown for comparison. During 1987 the NICs had invested in ASEAN about US\$0.3 billion compared to Japan's US\$1 billion. In Indonesia, for example, the NICs accounted for nearly 25% of all approved investment projects over 1967-88 compared to Japan's 38%. Hong Kong led the field with 12%, Taiwan 6%, Singapore 4%, and Korea 2.5%. Equally in 1984, nearly 25% of Korea's US\$0.4 billion FDI was concentrated in East Asia, and of that more than 25% was directed to the service sector, including finance.

The potential growth of FDI by the NICs in ASEAN countries, and in the rest of the world for that matter, reflects the growth of regionally based non-Japanese multinationals. These "new" multinationals can be classified under four broad categories depending on their historical or regional origins and functions. Given the diversity of the nature of these enterprises and the different circumstances under which they developed and operate, this classification serves only as a broad indicator as to their potential future development rather than as a definitive statement.

Firms with colonial antecedents such as Sime Darby in Singapore-Malaysia or Jardine Matheson in Hong Kong have been termed "expatriate" multinationals. Their main operations were primarily to develop and export regional resources and to trade in both goods and services. Some of these firms can be expected to evolve via alliances with western or Japanese companies into more traditional multinationals by entering the production and export of processed goods rather than commodities. In the financial sector, Hongkong Bank ranks amongst the twenty largest in the world and has an active programme of acquisitions in both Europe and the United States.

Secondly, there are companies of primarily Chinese origins which rely on ethnic links and networks for their operations. Their main activities concentrate

DIAGRAM 3



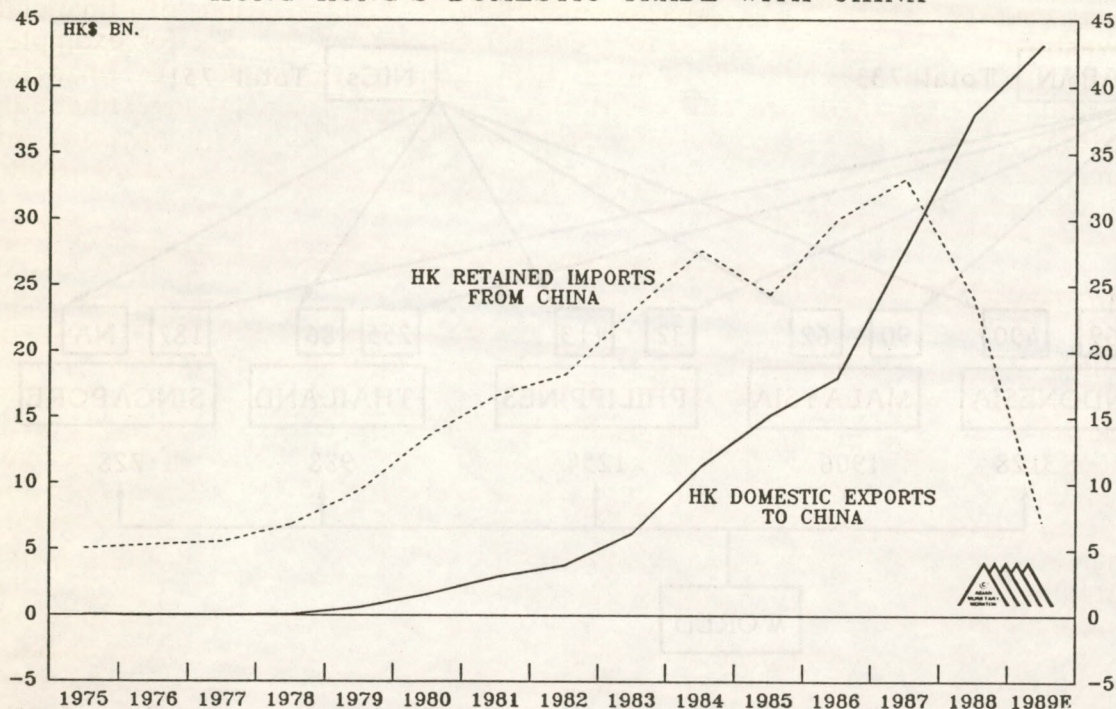
All figures in US\$ m1. Figures for Japan and the NICs, for 1988 (first half). World figures are annual averages for 1983-87 and include in addition to FDI, portfolio investment and other long term capital.

on property and finance. An example is the First Pacific Group (Indonesian chinese) with links in North America, Hong Kong, Philippines and Europe. The role of these particular groups may be strengthened by the potential flight of both people and capital from Hong Kong in the runup to 1997.

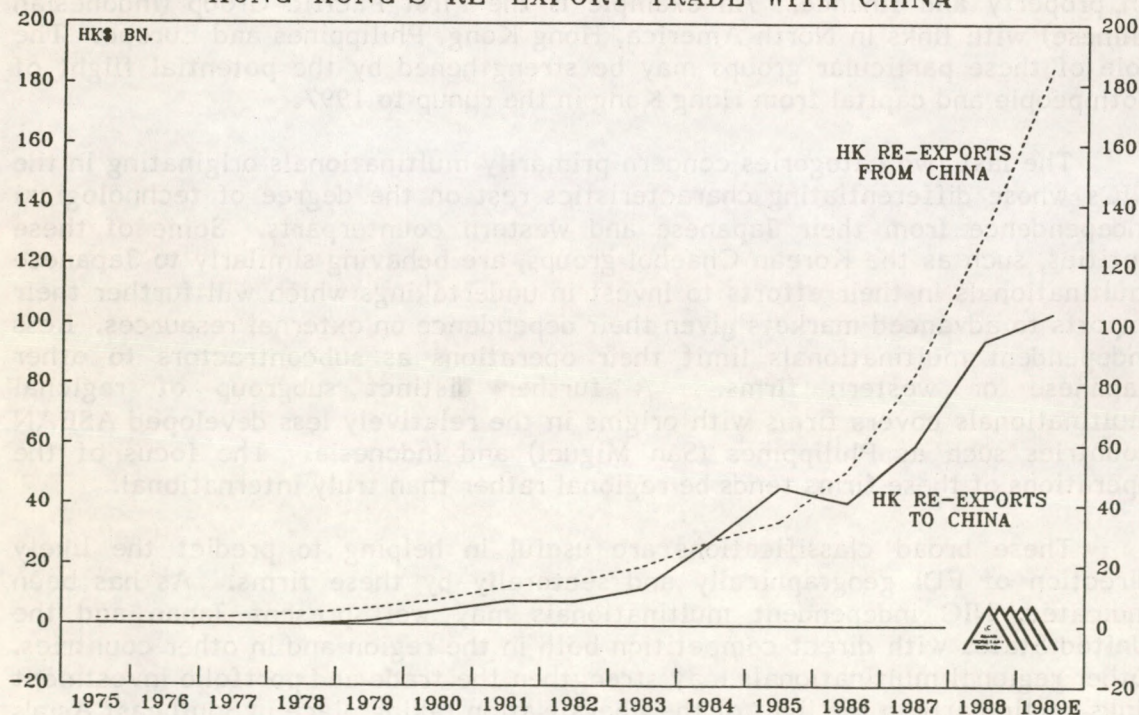
The last two categories concern primarily multinationals originating in the NICs whose differentiating characteristics rest on the degree of technological independence from their Japanese and western counterparts. Some of these entities, such as the Korean Chaebol groups, are behaving similarly to Japanese multinationals in their efforts to invest in undertakings which will further their exports to advanced markets given their dependence on external resources. Less independent multinationals limit their operations as subcontractors to other Japanese or western firms. A further distinct subgroup of regional multinationals covers firms with origins in the relatively less developed ASEAN countries such as Philippines (San Miguel) and Indonesia. The focus of the operations of these firms tends to be regional rather than truly international.

These broad classifications are useful in helping to predict the likely direction of FDI geographically and sectorally by these firms. As has been indicated, NIC independent multinationals may well present Japan and the United States with direct competition both in the region and in other countries. Other regional multinationals may strengthen the trade and portfolio investment links particularly in the light of the liberalisation taking place in Southeast Asia's trade and investment policies. It is worth stressing that statistics on FDI include

REGIONAL SURVEY: CHART 3
HONG KONG'S DOMESTIC TRADE WITH CHINA



REGIONAL SURVEY: CHART 4
HONG KONG'S RE-EXPORT TRADE WITH CHINA



participation of equity by foreigners of more than 10%, as well as "greenfield-type" of investment when a new production etc unit is created ab initio in the host country where there was none before. Liberalisation of financial investment rules can easily lead to greater freedom in FDI. So, for example, although Taiwan now has only limited restrictions on the outflow of financial capital and FDI, there are still restrictions on foreign financial investment in Taiwan. Korea still imposes restrictions on both inflows and outflows of financial and FDI but particularly so on outflows of financial investment and inflows of FDI.

The experience of Hong Kong with the development of trade and FDI is illuminating, although unique given the nature of its key partner the PRC. In 1980 the PRC took 4.2% of Hong Kong's domestic exports but in 1988 nearly 17.5%. Re-exports from Hong Kong in 1988 came to account for nearly 55% of total exports with re-exports to China taking 35% of all re-exports. This rapid growth of trade between the two economies gave rise to investment flows with Hong Kong being the most important source of FDI for China. In the second quarter of 1989 almost 76% of Hong Kong's domestic exports to China were for outward processing, meaning that these were exports of raw materials or semi-manufactures from Hong Kong to China for processing, with the resulting goods later re-imported into Hong Kong. For the same period re-exports to China for outward processing stood at 46% giving an overall figure of 54% of outward processing exports. The equivalent figure for 1988 was nearly 50%. It is obvious that the Hong Kong-PRC trade impinges directly on production relationships which, in their turn, are related to Hong Kong's FDI in China. In 1987, out of the 7,800 foreign enterprises in China 6,600 were from Hong Kong, accounting for 65% of all foreign investment. On a more modest scale the PRC has also invested in Hong Kong particularly in the property and the finance sector where the Bank of China group is the second most important in the local market after Hongkong Bank. This trade-FDI relationship is particularly sensitive to political developments as the post-June 1989 crisis of confidence has shown. Hong Kong's FDI flows can be expected to switch to other countries whilst the situation in China clarifies and stabilises.

FORECAST: Japan's position in the trade FDI flows with ASEAN and the NIC economies in absolute terms is still dominant but not unchanging in view of the emerging inter and intra ASEAN-NIC trade and FDI. As regional trade develops so will regional FDI given that enterprises and institutions capable of executing and benefiting from direct foreign investment already exist. Direct competition with Japanese multinationals, particularly in the service sectors is therefore unavoidable, less so in the technologically advanced sectors where Japan's relative advantage can be brought to bear. The speed of the development of NIC-ASEAN FDI will depend not only on the development of inter and intra ASEAN-NIC trade - and here the picture is not yet clearly defined - but also on institutional developments and in particular the liberalisation of inward and outward financial investment.

Reference

P.J. Buckley and H. Mirza The Strategy of Pacific Asian Multinationals, The Pacific Review Vol. 1, No. 1, 1988 pp. 50-62.

MALAYSIA ON A HIGHER GROWTH PATH

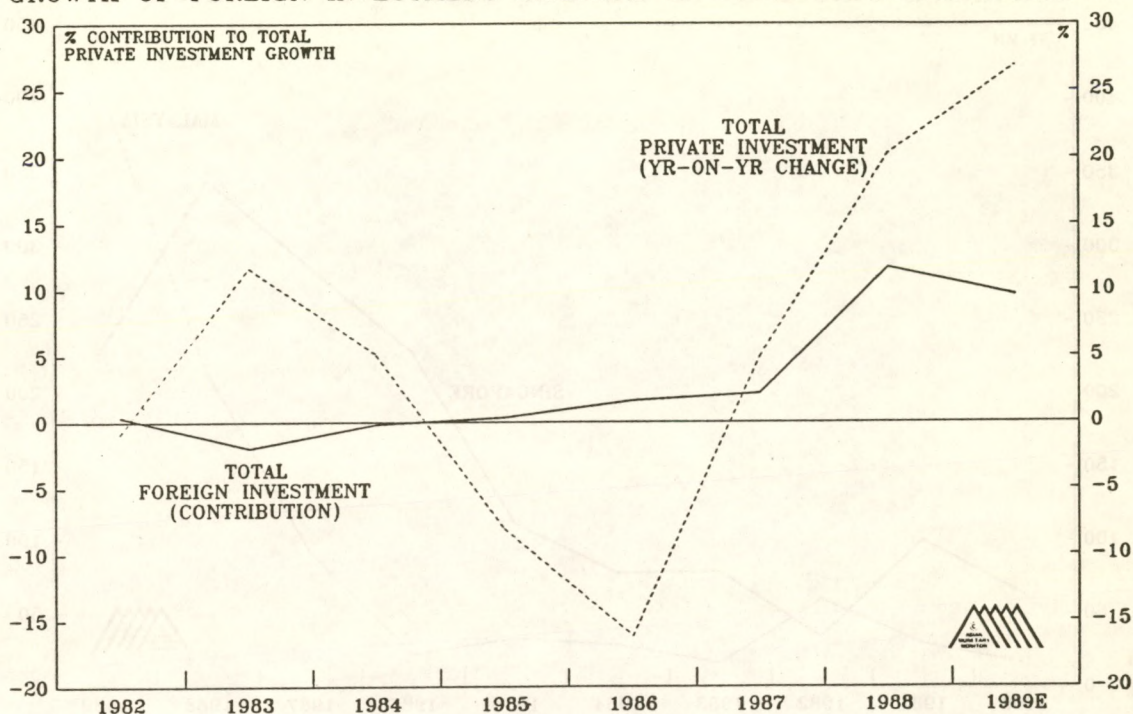
The Malaysian economy is continuing to grow very rapidly and should be one of the most rapidly growing economies in East Asia (and the world) over the next two or three years. Although the government has estimated that real GDP grew at a slower pace of 6.4% (year-on-year) in the second quarter, and forecast (in the budget for 1990, announced on October 27) a slowdown in growth to 7.6% for the whole of 1989 and 6.5% for calendar year 1990, the actual outcome is likely to be a stronger economic performance. In the absence of a world recession Malaysia is likely to be able to continue to achieve growth near the 8.7% rate recorded in 1988 for at least the next two years.

A surge in foreign direct investment played an important role in leading the Malaysian economy out of the recession of 1985/86. Direct investment, particularly from Japan, was originally attracted to South-East Asia by the improved competitive position of the South East Asian economies in the wake of the appreciation of the North East Asian and European currencies against the US dollar. Additionally, in the case of Malaysia, inflows were encouraged by the relaxation of regulations and improvement of incentives governing foreign investment introduced in 1986. For Malaysia the importance of the inflow of foreign investment was relatively greater than for the other South-East Asian economies by virtue of Malaysia's smaller economic size (see AMM Vol. 13 No. 3). A very crude estimate of the magnitude of the initial direct impact of foreign investment on the economy is given in Chart 1, which shows the 'contribution' of foreign investment, measured very approximately by the value of approved foreign equity for investment projects, to growth in the value of total private fixed capital formation, as measured in the nominal GDP. This chart indicates that roughly 40%-50% of the growth in total private investment over the past three years can be attributed to foreign investment.

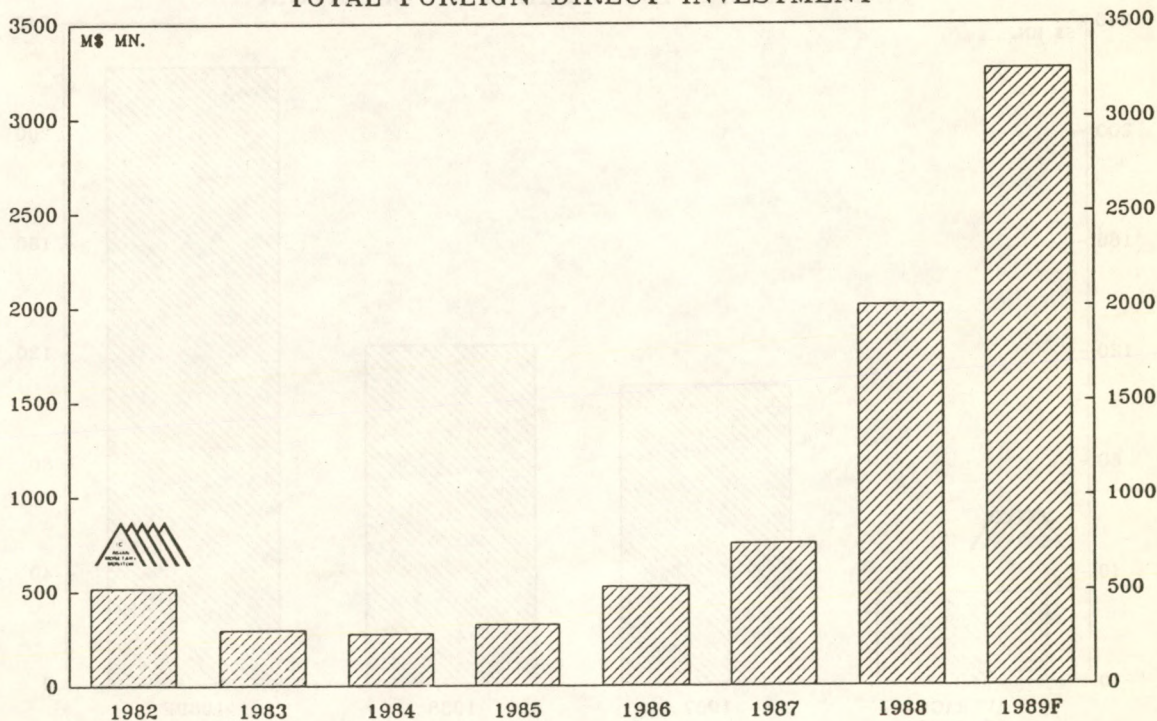
Most importantly for Malaysia's future prospects, there is as yet no sign of any real slackening in the growth of foreign investment. Based on figures for the first seven months, the value of foreign investment approvals in 1989 appears set to increase again by well over 50% from 1988 levels. Japanese direct investment in Malaysia is continuing to expand rapidly, with Malaysia now becoming a more important destination for investment by Japanese manufacturing companies in aggregate than Singapore (see Chart 3). During 1989 strong growth in investment from Japan and Taiwan has been supplemented by a near-doubling in investment by Singaporean concerns in Malaysia (Chart 4). In terms of number of projects, rather than value, the number of investments undertaken by Singaporean concerns annually now outweighs that by Japanese companies. Much of this investment is concentrated in Johor, the southern state of Peninsular Malaysia across the causeway from Singapore.

Although the very rapid rates of increase of foreign investment cannot be sustained indefinitely, Malaysia is likely to remain a favoured destination for investment in manufacturing by East Asian companies. The low interest rate, weak currency policy pursued by Bank Negara Malaysia (BNM) in 1988 (see AMM

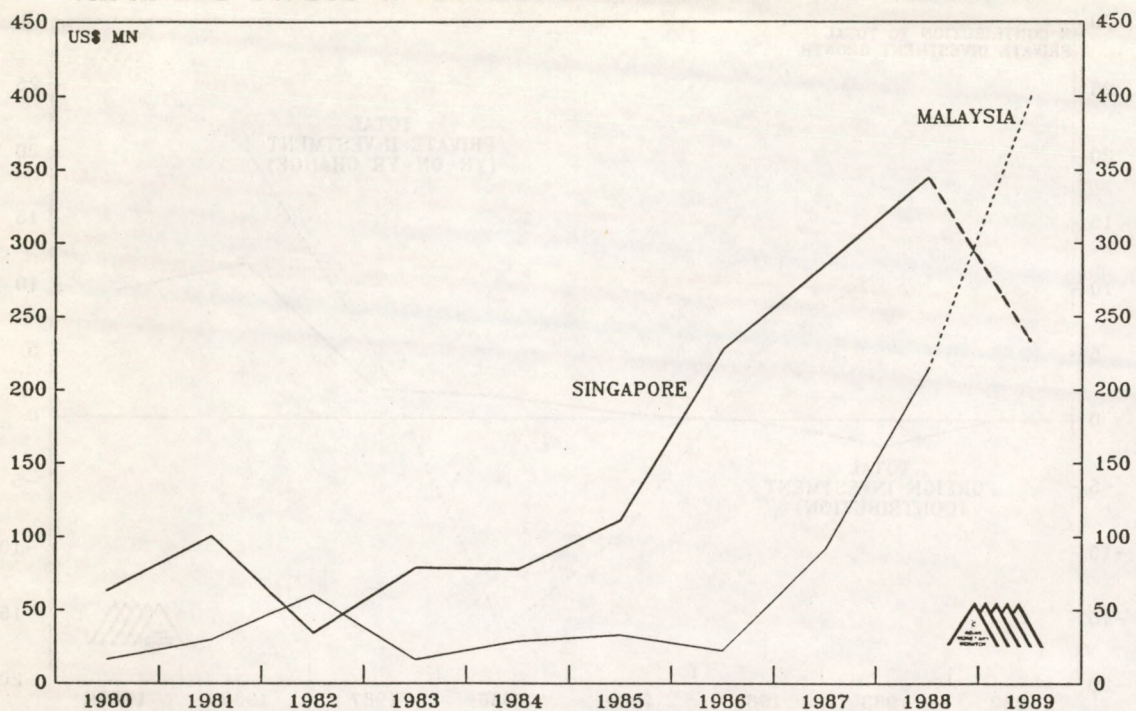
MALAYSIA: CHART 1
GROWTH OF FOREIGN INVESTMENT RELATIVE TO TOTAL PRIVATE INVESTMENT



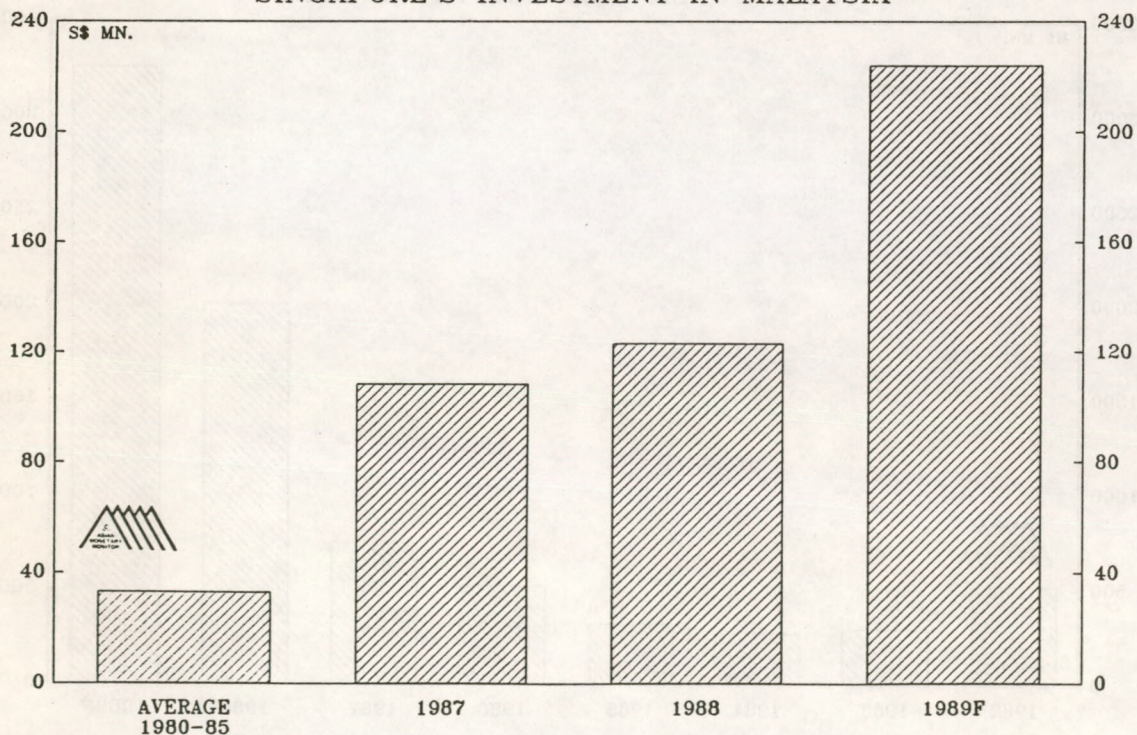
MALAYSIA: CHART 2
TOTAL FOREIGN DIRECT INVESTMENT



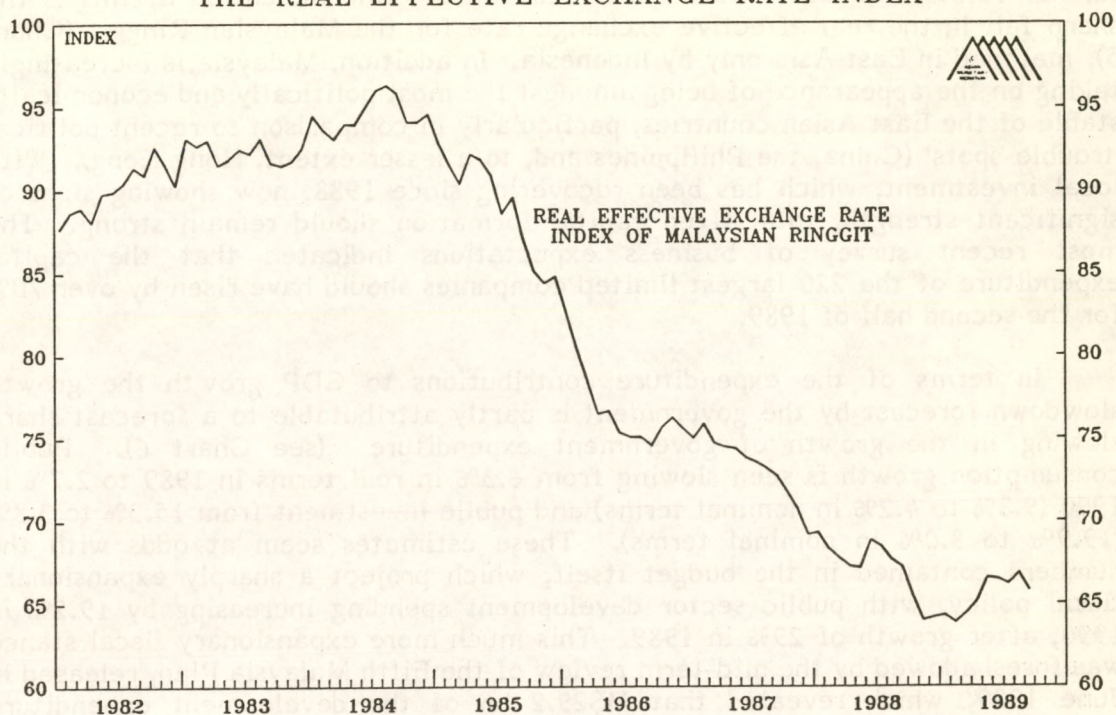
MALAYSIA: CHART 3
JAPANESE DIRECT INVESTMENT IN MALAYSIA AND SINGAPORE



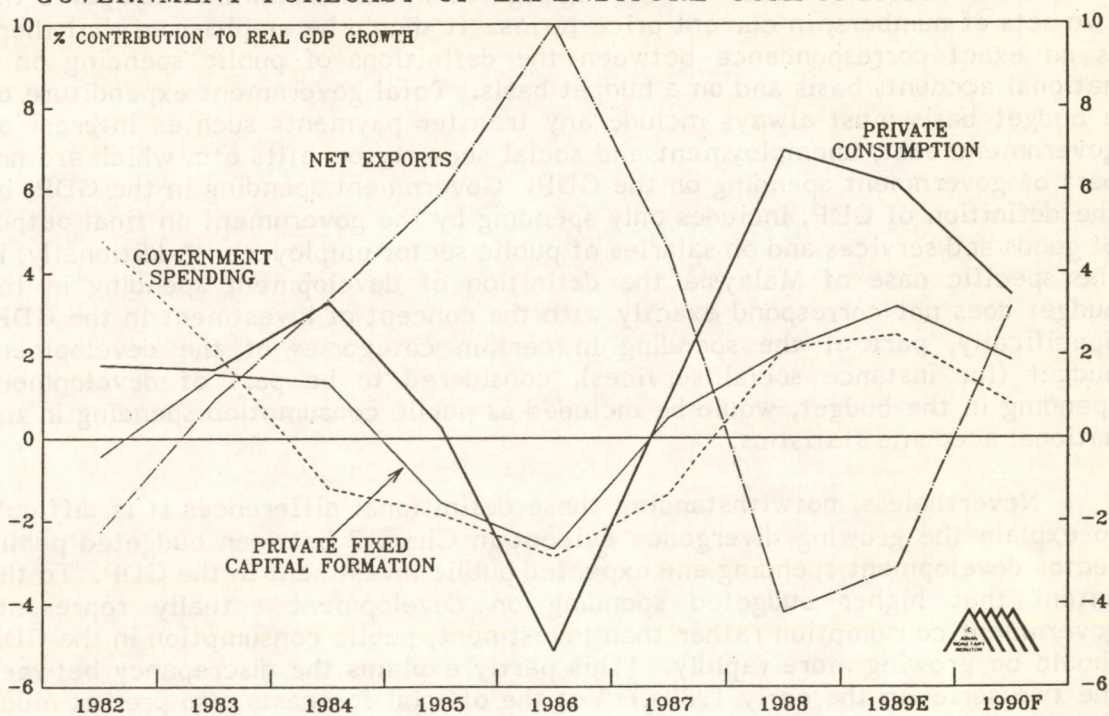
MALAYSIA: CHART 4
SINGAPORE'S INVESTMENT IN MALAYSIA



MALAYSIA: CHART 5
THE REAL EFFECTIVE EXCHANGE RATE INDEX



MALAYSIA: CHART 6
GOVERNMENT FORECAST OF EXPENDITURE COMPONENTS OF GDP



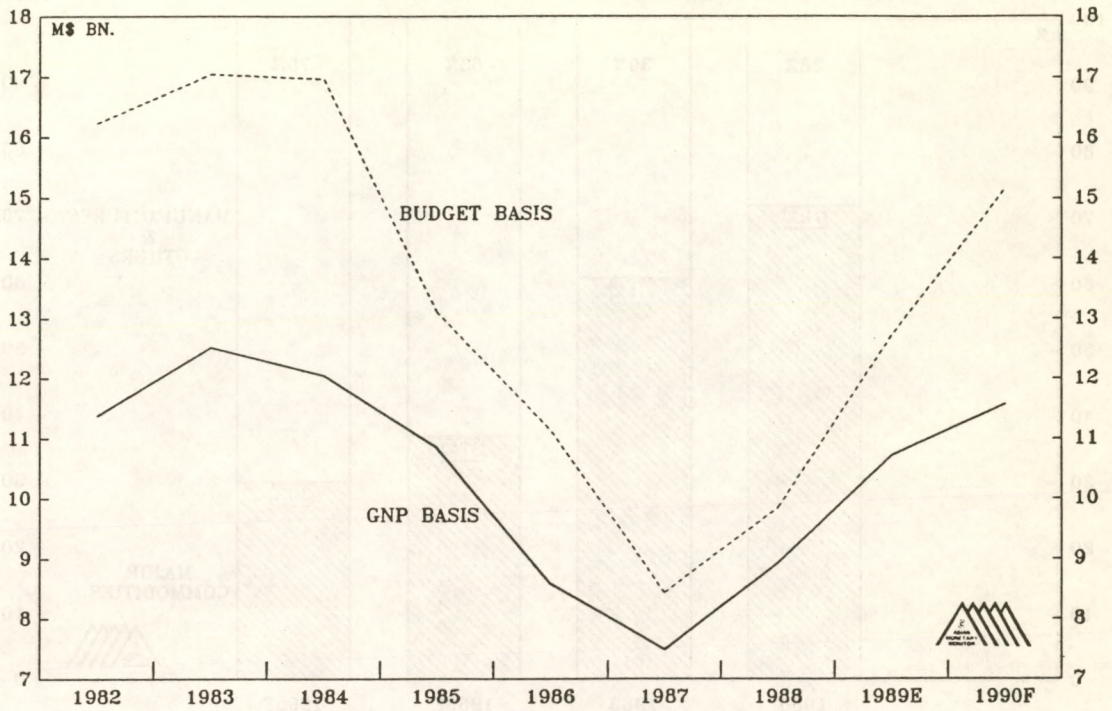
Vol. 13 No. 4) has had the effect of improving Malaysia's competitive position further relative to other East Asian economies. One indication of this is the sharp fall in the real effective exchange rate for the Malaysian Ringgit (Chart 5), matched in East Asia only by Indonesia. In addition, Malaysia is increasingly taking on the appearance of being amongst the most politically and economically stable of the East Asian countries, particularly in comparison to recent political 'trouble spots' (China, the Philippines and, to a lesser extent, Hong Kong). With local investment, which has been recovering since 1988, now showing signs of significant strength, total fixed capital formation should remain strong. The most recent survey of business expectations indicated that the capital expenditure of the 220 largest limited companies should have risen by over 70% for the second half of 1989.

In terms of the expenditure contributions to GDP growth the growth slowdown forecast by the government is partly attributable to a forecast sharp slowing in the growth of government expenditure (see Chart 6). Public consumption growth is seen slowing from 6.3% in real terms in 1989 to 2.7% in 1990 (9.8% to 4.2% in nominal terms) and public investment from 15.3% to 3.8% (19.9% to 8.0% in nominal terms). These estimates seem at odds with the numbers contained in the budget itself, which project a sharply expansionary fiscal policy, with public sector development spending increasing by 19.2% in 1990, after growth of 29% in 1989. This much more expansionary fiscal stance was foreshadowed by the mid-term review of the Fifth Malaysia Plan, released in June 1989, which revealed that M\$29.2 bn of the development expenditure anticipated for the plan period as a whole (1986-1990) remained unspent.

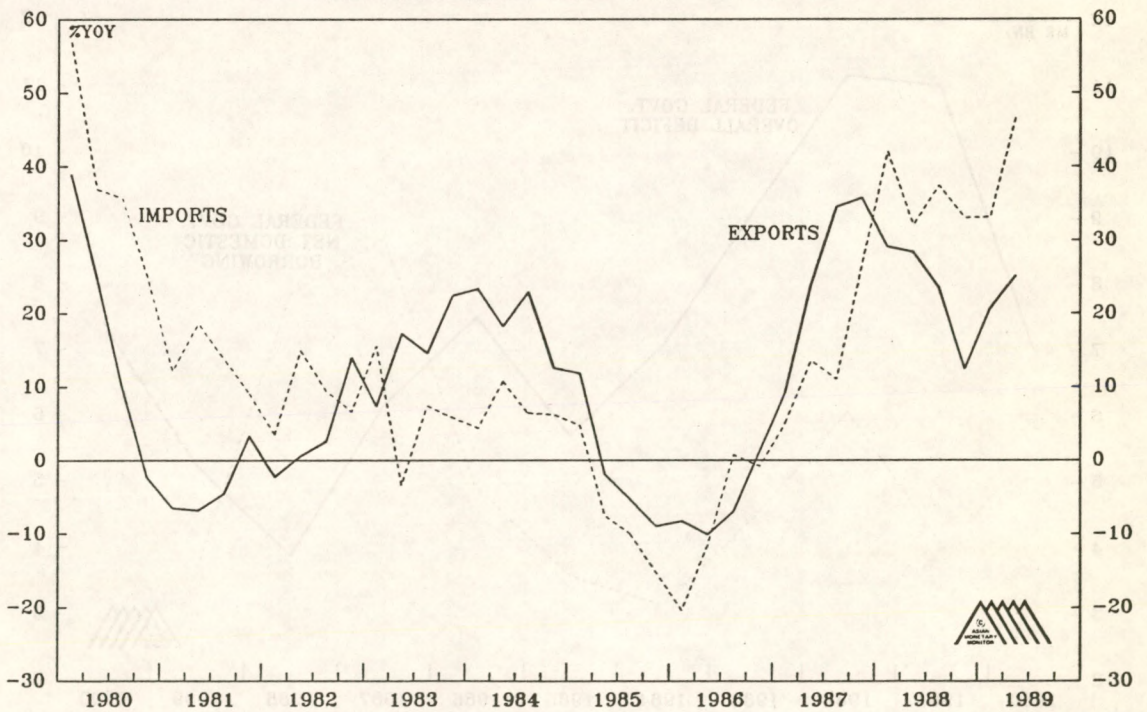
The apparent discrepancy between the budgeted figures for public sector development expenditure and the forecast for public fixed capital formation in the GDP estimates and forecast is highlighted in Chart 7, which compares the two sets of numbers, in current price terms. It should be emphasised that there is no exact correspondence between the definitions of public spending on a national accounts basis and on a budget basis. Total government expenditure on a budget basis must always include any transfer payments such as interest on government debt, unemployment and social security benefits etc. which are not part of government spending on the GDP. Government spending in the GDP, by the definition of GDP, includes only spending by the government on final output of goods and services and on salaries of public sector employees. Additionally, in the specific case of Malaysia the definition of development spending in the budget does not correspond exactly with the concept of investment in the GDP. Specifically, part of the spending in certain categories of the development budget (for instance social services), considered to be part of development spending in the budget, would be included as public consumption spending in the national accounts statistics.

Nevertheless, notwithstanding these definitional differences it is difficult to explain the growing divergence evident in Chart 7 between budgeted public sector development spending and expected public investment in the GDP. To the extent that higher budgeted spending on development actually represents government consumption rather than investment, public consumption in the GDP should be growing more rapidly. (This partly explains the discrepancy between the two series in the early 1980s.) Yet the official forecasts also predict much slower growth in public consumption in 1990. More likely government spending

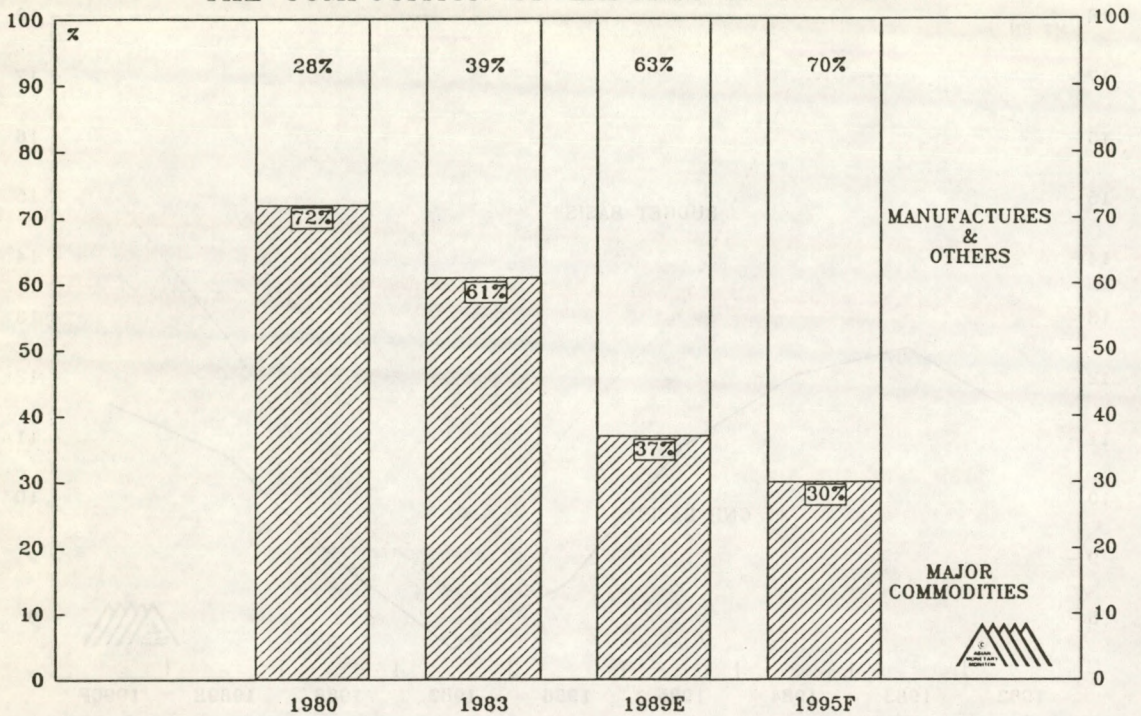
MALAYSIA: CHART 7
GOVERNMENT INVESTMENT



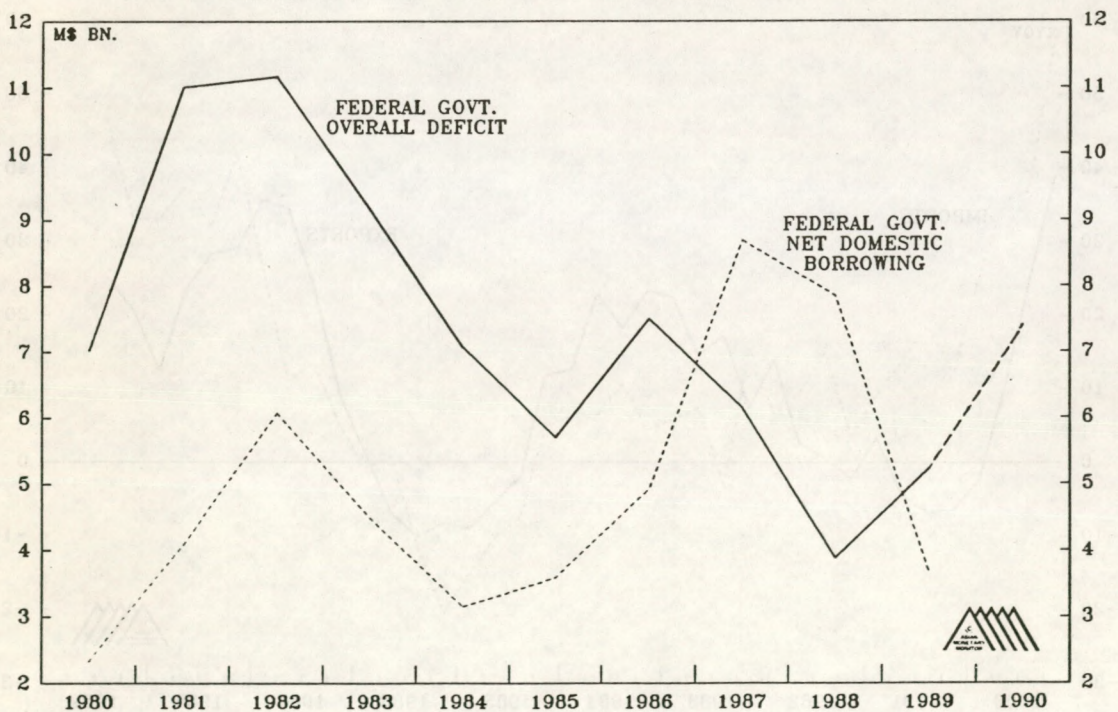
MALAYSIA: CHART 8
EXPORTS AND IMPORTS GROWTH



MALAYSIA: CHART 9
THE COMPOSITION OF EXPORTS IS CHANGING



MALAYSIA: CHART 10
GOVERNMENT DEFICIT AND DOMESTIC BORROWING



growth over 1989-90 will turn out to be higher than official forecasts for GDP growth are indicating.

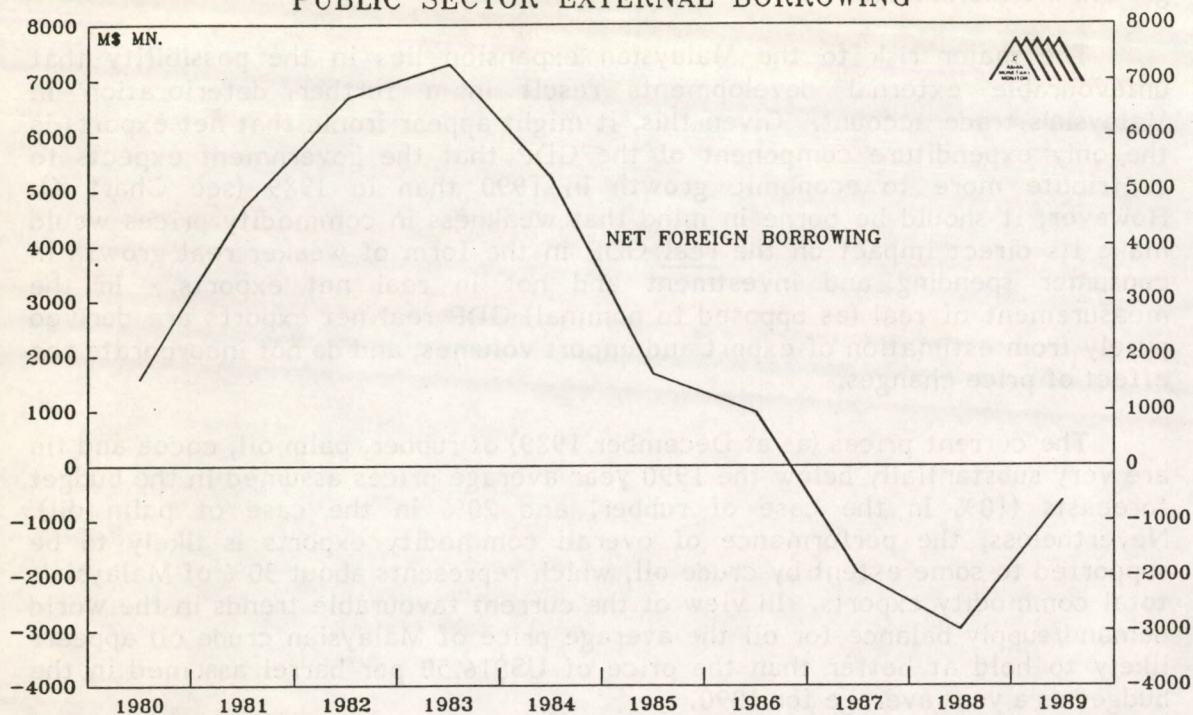
The major risk to the Malaysian expansion lies in the possibility that unfavourable external developments result in a further deterioration in Malaysia's trade account. Given this, it might appear ironic that net exports is the only expenditure component of the GDP that the government expects to contribute more to economic growth in 1990 than in 1989 (see Chart 6). However, it should be borne in mind that weakness in commodity prices would make its direct impact on the real GDP in the form of weaker real growth in consumer spending and investment and not in real net exports. In the measurement of real (as opposed to nominal) GDP real net exports are derived purely from estimation of export and import volumes, and do not incorporate the effect of price changes.

The current prices (as at December 1989) of rubber, palm oil, cocoa and tin are very substantially below the 1990 year average prices assumed in the budget forecasts (10% in the case of rubber, and 20% in the case of palm oil). Nevertheless, the performance of overall commodity exports is likely to be supported to some extent by crude oil, which represents about 30% of Malaysia's total commodity exports. In view of the current favourable trends in the world demand/supply balance for oil the average price of Malaysian crude oil appears likely to hold at better than the price of US\$16.50 per barrel assumed in the budget as a year average for 1990.

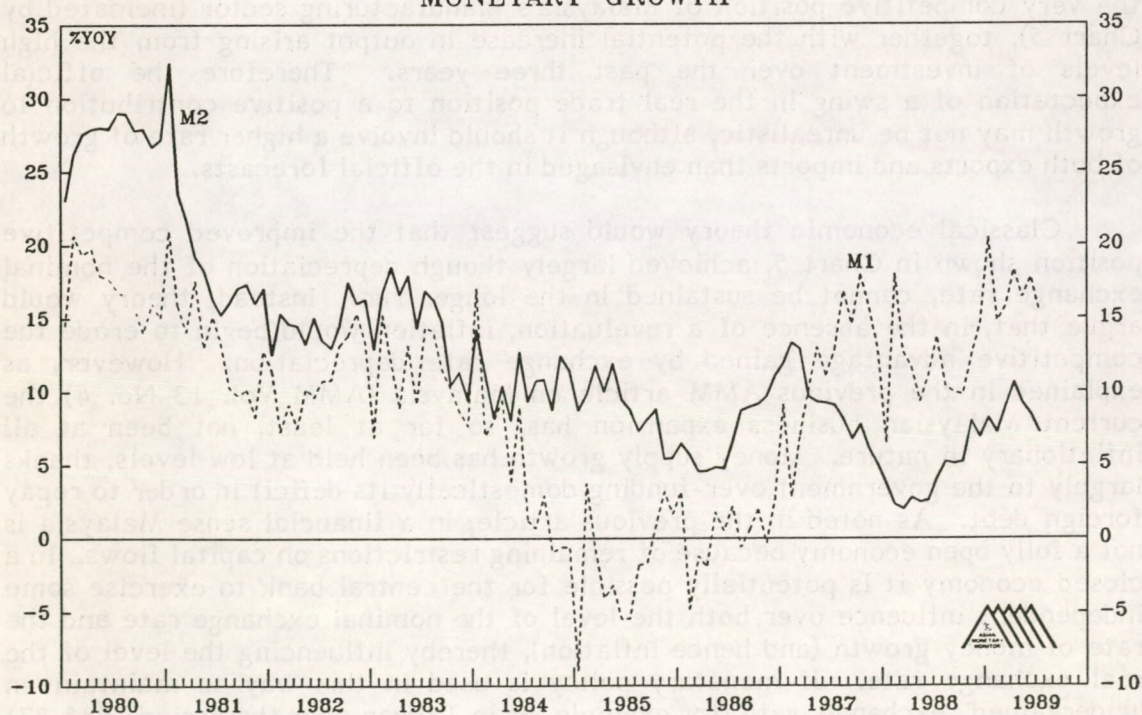
More important is that commodities now represent the smaller part of Malaysia's total exports relative to manufactured goods (see Chart 9). Notwithstanding the likelihood of a slow rate of world economic growth in 1990 the outlook for Malaysia's manufactured exports is fairly positive, supported by the very competitive position of Malaysia's manufacturing sector (indicated by Chart 5), together with the potential increase in output arising from the high levels of investment over the past three years. Therefore the official expectation of a swing in the real trade position to a positive contribution to growth may not be unrealistic, although it should involve a higher rate of growth of both exports and imports than envisaged in the official forecasts.

Classical economic theory would suggest that the improved competitive position shown in Chart 5, achieved largely through depreciation of the nominal exchange rate, cannot be sustained in the longer run. Instead, theory would argue that, in the absence of a revaluation, inflation would begin to erode the competitive advantage gained by exchange rate depreciation. However, as explained in the previous AMM article on Malaysia (AMM Vol. 13 No. 4) the current Malaysian business expansion has, so far at least, not been at all inflationary in nature. Money supply growth has been held at low levels, thanks largely to the government over-funding domestically its deficit in order to repay foreign debt. As noted in the previous article, in a financial sense Malaysia is not a fully open economy because of remaining restrictions on capital flows. In a closed economy it is potentially possible for the central bank to exercise some independent influence over both the level of the nominal exchange rate and the rate of money growth (and hence inflation), thereby influencing the level of the real exchange rate. If monetary policy is used in this way to maintain an 'undervalued' exchange rate (for example, as in Taiwan over the period 1985-87)

MALAYSIA: CHART 11
PUBLIC SECTOR EXTERNAL BORROWING



MALAYSIA: CHART 12
MONETARY GROWTH



then the main effect on the economy will tend to be to encourage greater growth in the externally-oriented (i.e. trade related) sector of the economy at the expense of the 'domestic' parts of the economy.

In Malaysia, in 1987 and 1988 the important contractionary influence upon money growth was the Federal government's domestic over-funding of its deficit in order to repay foreign debt. With the change in fiscal policy indicated by the October budget this negative influence upon money growth has now disappeared (see Charts 10 and 11). Nevertheless, Bank Negara has attempted to maintain a tight rein over monetary conditions through its own actions to drain liquidity (see AMM Vol. 13 No. 4). Following a 1% increase in statutory reserve requirements in April (the first increase in reserve requirements since 1974) BNM announced a further increase in reserve requirements, again of 1%, in October, equivalent to an additional net withdrawal of high powered money of over M\$600 million.

Raising the amount of reserve deposits at the central bank that banks are required to hold against their eligible liabilities imposes a cost upon banks (the loss of interest from loans or investments that they otherwise would have made) which the banks will probably attempt to pass on to their customers. Therefore a rise in reserve requirements is akin to a tax on bank customers and/or shareholders and in this respect is little different from raising taxes to increase the contractionary impact (or reduce the stimulative influence) on money growth of the government's budgetary operations. As long as the underlying sources of monetary base growth (particularly the external, or balance of payments source) remain expansionary a rise in reserve requirements is only likely to have a temporary subduing impact upon the rate of money growth unless it is repeated. If the underlying foreign source of monetary base growth remains expansionary because the currency is being held at artificially 'undervalued' levels, eventually inflationary pressures will emerge in the economy.

FORECAST: In Malaysia's case the key to whether or not serious inflationary pressures will eventually become evident is to what extent, if at all, the current level of the real effective exchange rate for the Malaysian Ringgit, indicated by Chart 5, does represent a genuine 'undervaluation' of the Malaysian currency. If the Ringgit is significantly undervalued, and remains so, this will begin to show up in the development of a chronic basic balance of payments surplus and, ultimately, higher inflation. Currently none of the classic symptoms of 'over-heating' - in particular a high rate of money growth - are present. The more rapid rate of economic growth that Malaysia is enjoying is instead the result of the very rapid structural change in the economy towards a greater manufacturing orientation, which is moving the Malaysian economy on to a higher secular growth path.

If the current business expansion does ultimately end in a period of 'over-heating' then this is likely to involve, at least for a time, a period of more rapid growth in GDP. In the meantime any slowdown in economic growth which might result from external factors - i.e. a sharp slowdown in the world economy - should be fairly temporary. The official forecast of weaker Malaysian growth led by a weakening in the domestic areas of the economy is likely to prove incorrect.

SOUTH KOREA

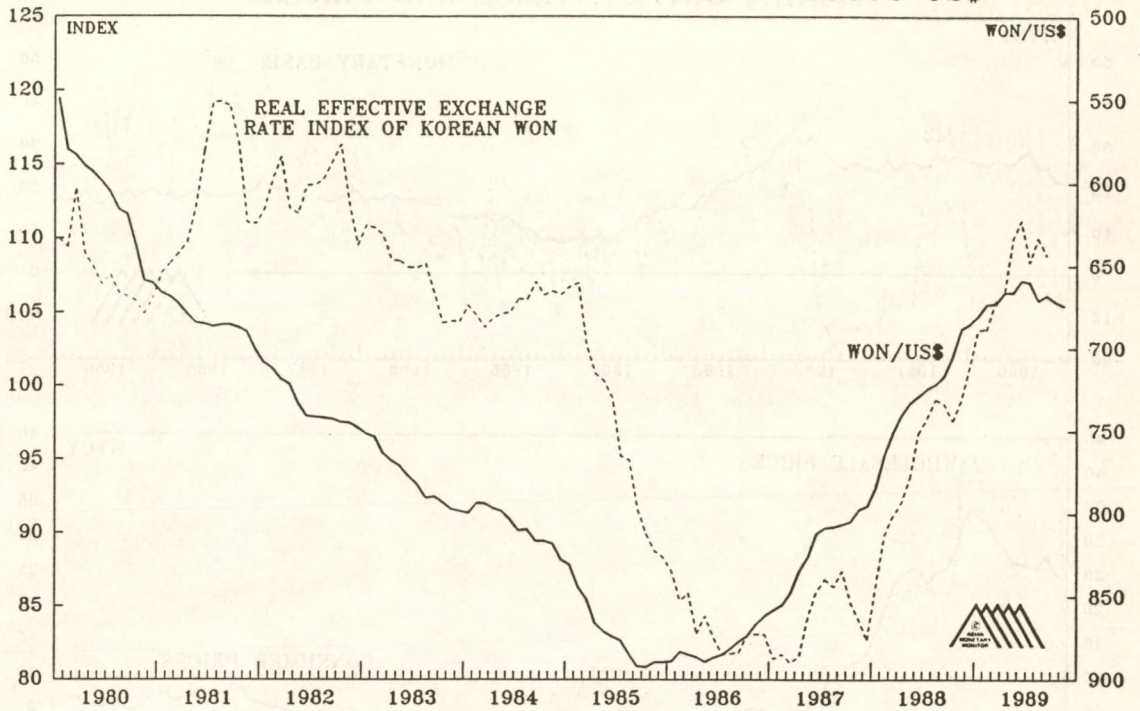
ADJUSTMENT WITHOUT REFLATION

1989 has been a difficult year for the Korean economy. Most of the difficulties have stemmed from the revaluation of the Won and the resultant loss in competitiveness. In 1988 the Won appreciated from 800 per US\$ to around 680 (see Chart 1), while the real effective exchange rate, an inflation-adjusted measure of competitiveness on a multi-lateral basis, rose from 82 to 102, implying a loss of competitiveness of approximately 24%. In 1989 the Won appreciated further from 680 per US\$ to 660 in mid-year, although it has subsequently fallen back to around 675. Because the US\$ appreciated against most currencies in 1989 the real effective exchange rate for the Korean Won rose again, this time from 102 to 112, a rise of approximately 10%, though it has subsequently fallen back to 109. The loss of international competitiveness has led to a slump in export growth (Chart 2) and a sharp reduction in South Korea's external surplus. On a twelve month moving total basis the trade balance has declined from a surplus of US\$ 8.9 billion at the end of 1988 to less than US\$ 1.9 billion at the end of 1989. In addition to the collapse of the external surplus, the country has seen serious labour unrest during the year and these troubles are by no means over. Finally, the real economic growth rate has roughly halved from 12.2% in 1988 to 6.5% in 1989, and is expected to show a growth rate of "only" 5.0 - 6.5% in 1990.

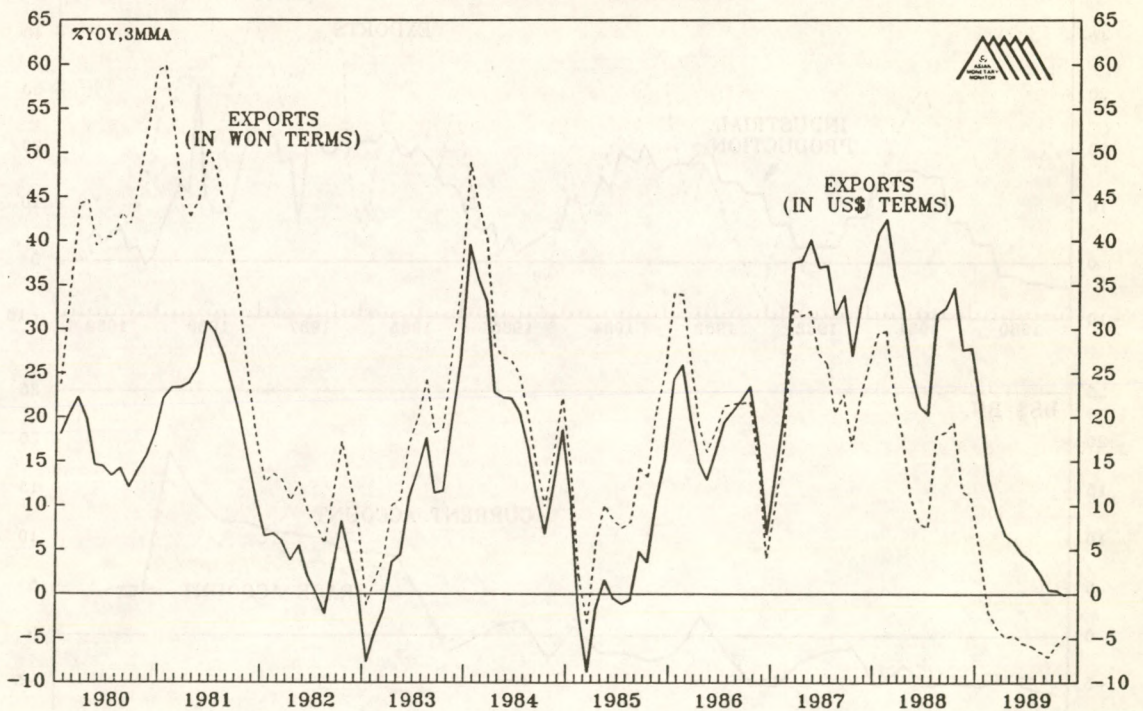
Alongside this sharp slowdown in the rate of growth of the overall GNP there has been a dramatic change in the composition of overall spending during 1989. In the early stages of the business cycle expansion, growth was export-led, in the sense that net exports made a disproportionately large contribution to real GNP growth, while domestic demand grew at a comparatively modest rate (Chart 4). Since late 1988 the composition of growth has changed abruptly with domestic demand (consumption and investment) taking the leading role and net exports contributing negatively, particularly during 1989. Parallel with these changes the growth in the index of industrial production has slowed significantly (Chart 3) and Koreans are starting to be concerned about the longer term prospects for the growth of their industrial machine. However, the pain induced by the current slowdown should not be exaggerated. In the first place double digit growth at 12-13% is unsustainable for a relatively mature industrial economy. Second, despite the slowdown in exports and industrial production, other sectors of the domestic economy such as construction and retail spending have remained relatively buoyant. These changes in the composition of the GNP are similar to the change in the pattern of growth experienced by Japan and other East Asian economies during the current business cycle. The comparison with Japan is particularly instructive because the two economies have so many similarities, but there has also been one important difference in terms of the policy response of the authorities to the appreciation in the currencies of the two economies.

The major difference between Japan and Korea is that whereas both economies experienced a sharp appreciation of their currencies between 1985 and 1988, in the case of Japan the recessionary effects which might have been

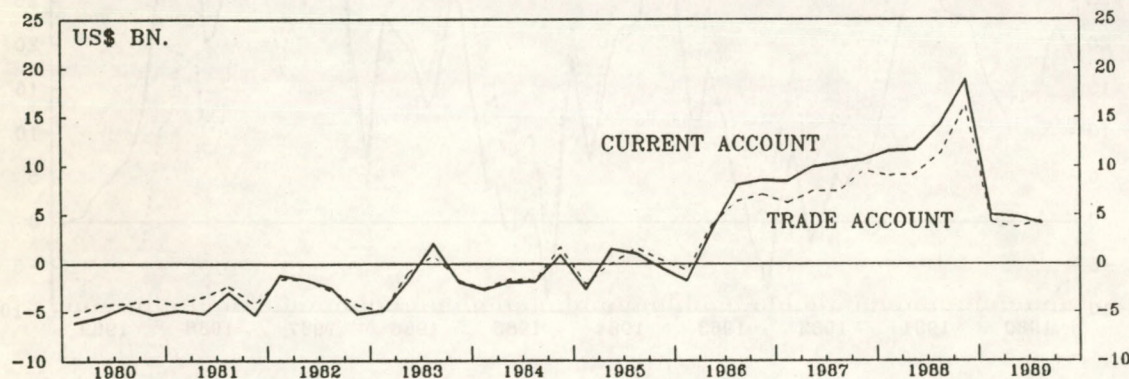
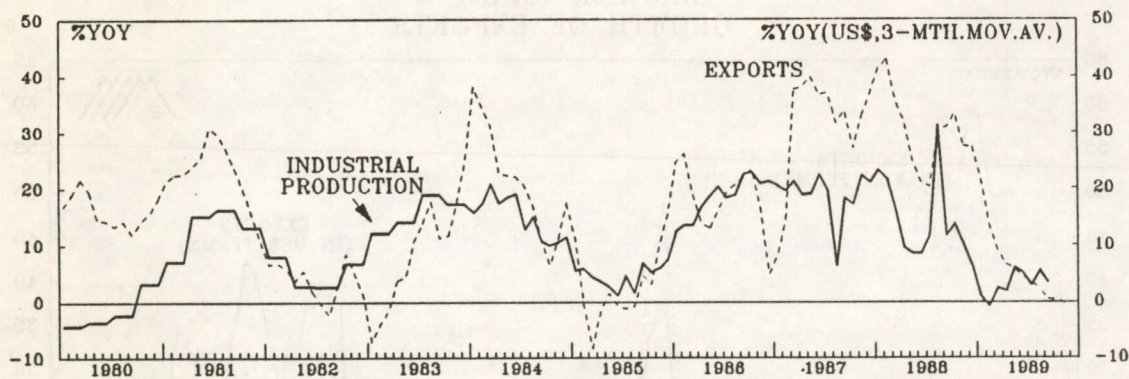
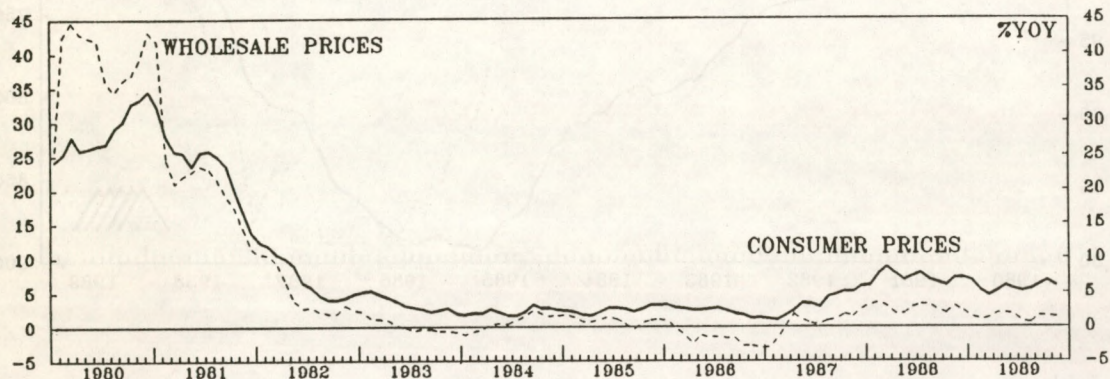
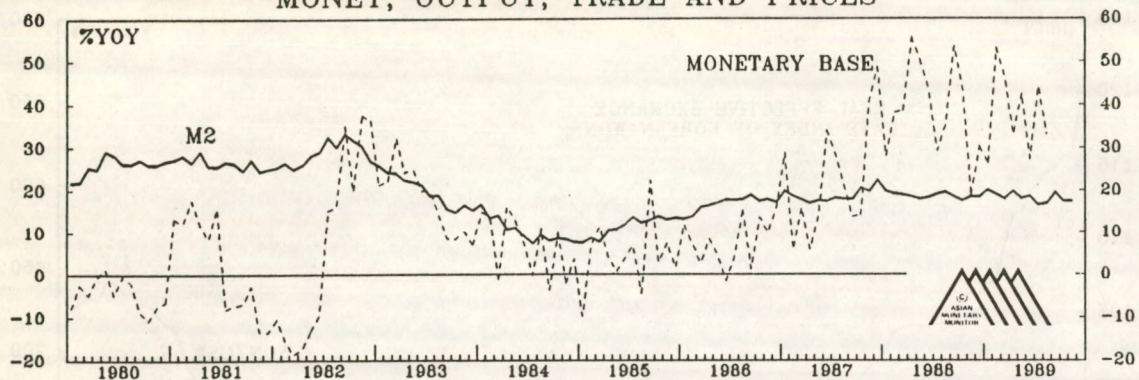
S.KOREA: CHART 1
REAL EFFECTIVE EXCHANGE RATE AND VERSUS US\$



S.KOREA: CHART 2
GROWTH OF EXPORTS



S.KOREA: CHART 3 MONEY, OUTPUT, TRADE AND PRICES



produced by the yen's appreciation were avoided by a substantial acceleration in the rate of monetary growth. In effect the "en-daka fukyo" (recession due to Yen appreciation) was avoided by monetary inflation. By allowing M2 plus CDs to accelerate from 8% to 12% the Japanese authorities injected a powerful stimulus to the domestic economy which showed up initially in the form of strongly rising asset prices and later in a more general rise in nominal expenditures on investment and consumption. Subsequently the monetary acceleration has begun to show itself in a gradual rise in the core rate of inflation in Japan (see Economic Capsule, p. 30). In the case of Korea, by contrast, the authorities did not seek such an easy way out of the slowdown induced by the appreciation of the Won. The Koreans initially adopted a much tougher adjustment strategy, persistently sterilising monetary inflows from the balance of payments in order to prevent the money supply from increasing at a rate in excess of their chosen target of 18%. In other words, despite the balance of payments surplus and despite the adverse consequences of the Won's appreciation, the Korean authorities have faithfully adhered to their M2 targets (Chart 5). As a result, asset prices in Korea have not risen nearly as much as they have in Japan. Also the nominal GNP has not shown any acceleration comparable to that in Japan in 1988-89. The inflation rate for goods and services in Korea has been somewhat higher than in Japan, averaging 6% in 1988 and 1989, but the core rate of inflation in Korea was higher at the start of the whole episode in 1985.

In general terms there are four possible macro-economic adjustment policies available to South Korea, shown in tabular form below.

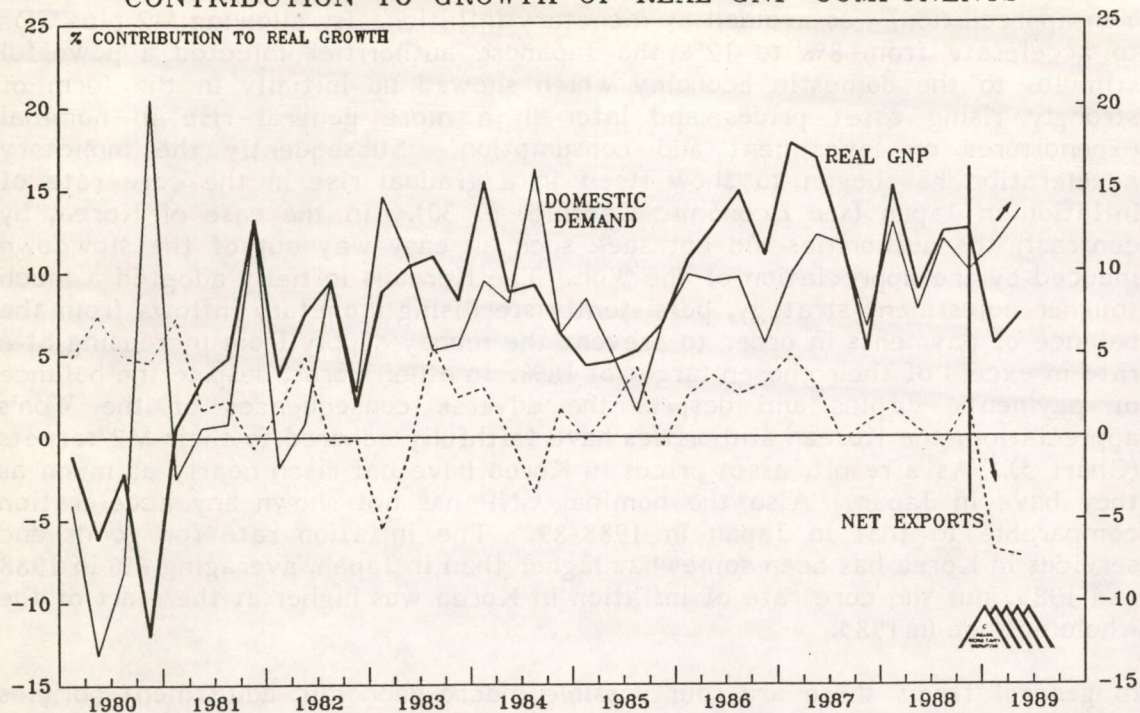
Table 1
MACRO-ECONOMIC ADJUSTMENT OPTIONS

Option	Money Supply Growth Rate	Exchange Rate Won/US\$
1.	Unchanged	Unchanged
2.	Faster	Unchanged
3.	Unchanged	Depreciate Won
4.	Faster	Depreciate Won

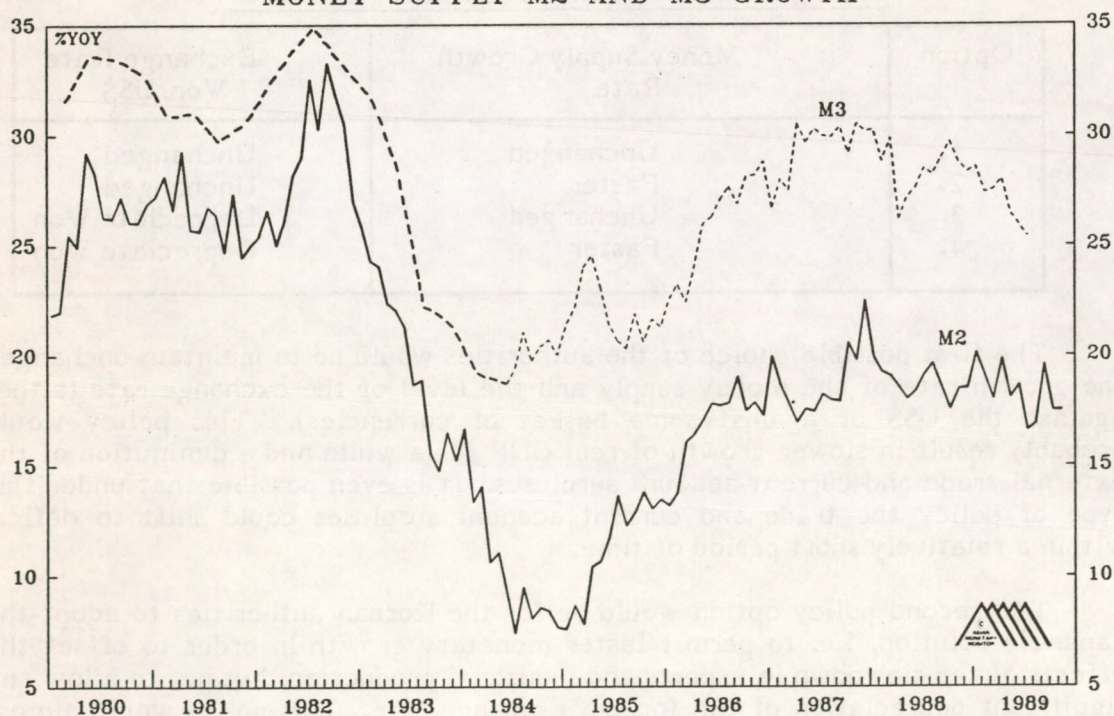
The first possible choice of the authorities would be to maintain unchanged the growth rate of the money supply and the level of the exchange rate (either against the US\$ or against some basket of currencies). This policy would probably result in slower growth of real GNP for a while and a diminution of the external trade and current account surpluses. It is even possible that under this type of policy the trade and current account surpluses could shift to deficit within a relatively short period of time.

The second policy option would be for the Korean authorities to adopt the Japanese solution, i.e. to permit faster monetary growth in order to offset the effects of the slowdown in exports and industrial production, but not to allow any significant depreciation of the foreign exchange rate. This policy would almost certainly stimulate domestic demand after some lag, but it would undoubtedly

S.KOREA: CHART 4
CONTRIBUTION TO GROWTH OF REAL GNP COMPONENTS



S.KOREA: CHART 5
MONEY SUPPLY M2 AND M3 GROWTH



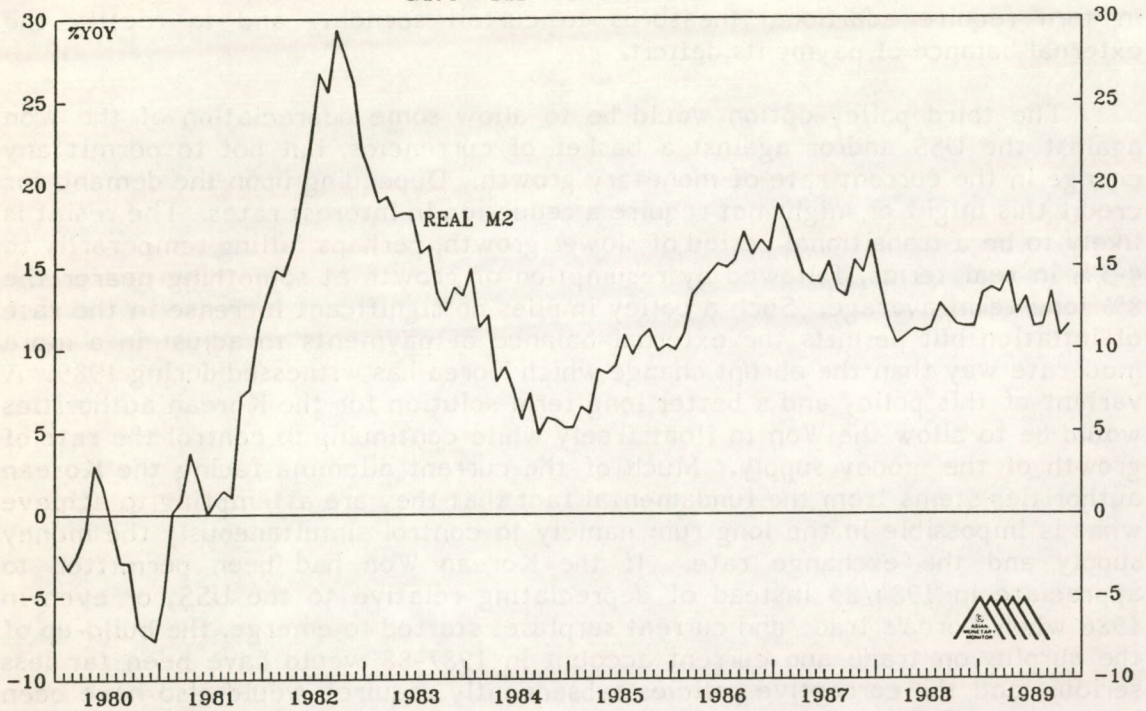
also lead to a further sharp deterioration in the external trade and current accounts. Over time it would also lead to higher inflation in Korea which would in turn require additional measures to curtail spending and to rectify the external balance of payments deficit.

The third policy option would be to allow some depreciation of the Won against the US\$ and/or against a basket of currencies, but not to permit any change in the current rate of monetary growth. Depending upon the demand for credit this might or might not require a reduction in interest rates. The result is likely to be a transitional period of slower growth, perhaps falling temporarily to 4-5% in real terms, followed by resumption of growth at something nearer the 8% long term average. Such a policy implies no significant increase in the rate of inflation but permits the external balance of payments to adjust in a more moderate way than the abrupt change which Korea has witnessed during 1989. A variant of this policy and a better long term solution for the Korean authorities would be to allow the Won to float freely while continuing to control the rate of growth of the money supply. Much of the current dilemma facing the Korean authorities stems from the fundamental fact that they are attempting to achieve what is impossible in the long run: namely to control simultaneously the money supply and the exchange rate. If the Korean Won had been permitted to appreciate in 1984/85 instead of depreciating relative to the US\$, or even in 1986 when Korea's trade and current surpluses started to emerge, the build-up of the surplus on trade and current account in 1987-88 would have been far less serious, and the corrective policies subsequently required would also have been correspondingly less severe. Again, this provides an interesting contrast with Japan where the Yen has been allowed to float rather more freely, where capital flows have also been much less restricted, and where as a result the correction of the trade and current account surplus has been much more gradual.

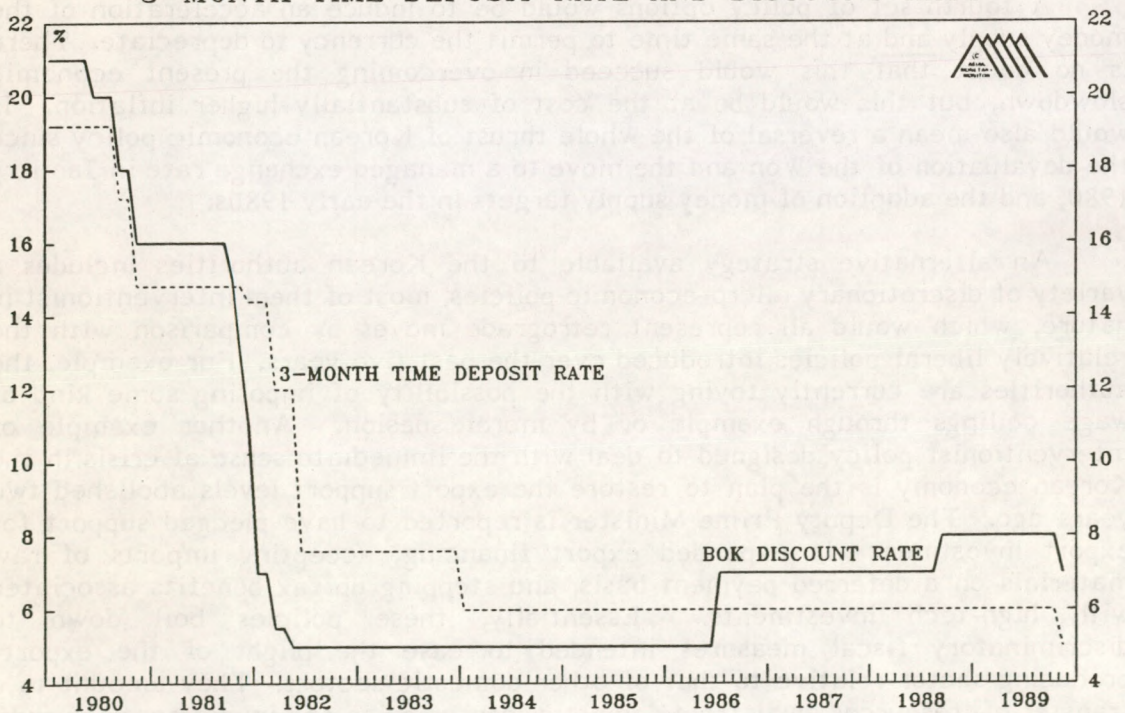
A fourth set of policy options would be to induce an acceleration of the money supply and at the same time to permit the currency to depreciate. There is no doubt that this would succeed in overcoming the present economic slowdown, but this would be at the cost of substantially higher inflation. It would also mean a reversal of the whole thrust of Korean economic policy since the devaluation of the Won and the move to a managed exchange rate in January 1980, and the adoption of money supply targets in the early 1980s.

An alternative strategy available to the Korean authorities includes a variety of discretionary micro-economic policies, most of them interventionist in nature, which would all represent retrograde moves by comparison with the relatively liberal policies introduced over the past five years. For example, the authorities are currently toying with the possibility of imposing some kind of wage ceilings through example or by moral suasion. Another example of interventionist policy designed to deal with the immediate sense of crisis in the Korean economy is the plan to restore the export support levels abolished two years ago. The Deputy Prime Minister is reported to have pledged support for export investment via expanded export financing, accepting imports of raw materials on a deferred payment basis, and stepping up tax benefits associated with high-tech investments. Essentially, these policies boil down to discriminatory fiscal measures intended to ease the plight of the export-producing sector relative to that of other domestic sectors. They amount to a transfer of resources away from domestic consumption and investment towards

S.KOREA: CHART 6
GROWTH OF REAL M2



S.KOREA: CHART 7
3-MONTH TIME DEPOSIT RATE AND DISCOUNT RATE

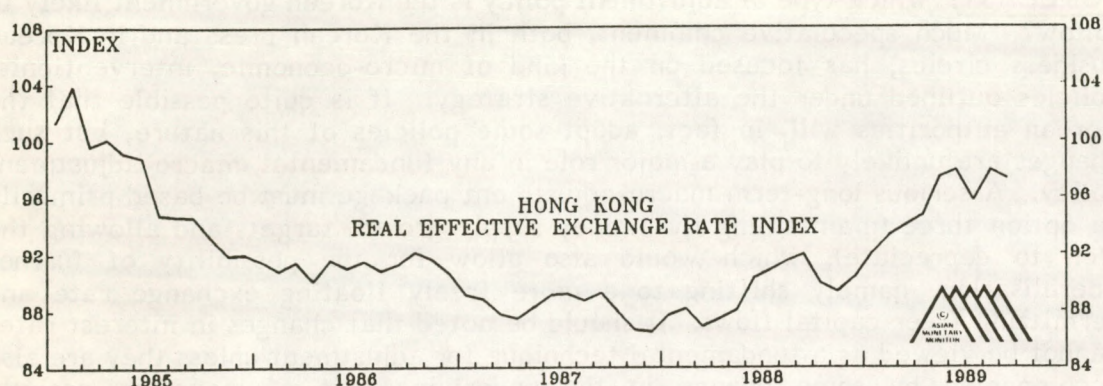


export-oriented investment and production - a fundamental reversal of the policies which have been pursued in recent years.

FORECAST: Which type of adjustment policy is the Korean government likely to follow? Much speculative comment, both in the Korean press and in Korean business circles, has focused on the kind of micro-economic, interventionist policies outlined under the alternative strategy. It is quite possible that the Korean authorities will, in fact, adopt some policies of this nature, but such changes are unlikely to play a major role in any fundamental, macro-adjustment policy. A serious long-term macro-adjustment package must be based primarily on option three (maintaining the money supply growth targets and allowing the Won to depreciate), which would also allow for the possibility of further liberalisation, namely shifting to a more freely floating exchange rate and permitting freer capital flows. It should be noted that changes in interest rates cannot be viewed as a fundamental technique for adjustment unless they are also accompanied by some change in the underlying rate of monetary growth. Therefore, despite the recent reduction in the official discount rate on November 14 - which might suggest the adoption of option two or option four - it is not clear that faster monetary growth will automatically result. It might simply be that owing to weaker credit demand from the industrial export sector, some reduction in interest rates is warranted to maintain existing rates of monetary growth.

The adjustment policy being pursued by the Korean authorities provides a textbook opportunity to compare a policy of monetary reflation as a means of adjustment (Japan) with a policy of adjustment without monetary reflation (Korea). At worst, under option 1, Korea will experience a year or so of slower growth with some painful restructuring of industry. At best, under option 3, Korea will emerge with a more liberal policy in respect of capital inflows and outflows, a more freely floating exchange rate, but with an unchanged policy vis-a-vis maintaining steady growth of the money supply.

HONG KONG: DOMESTIC EXPORTS WILL REMAIN WEAK

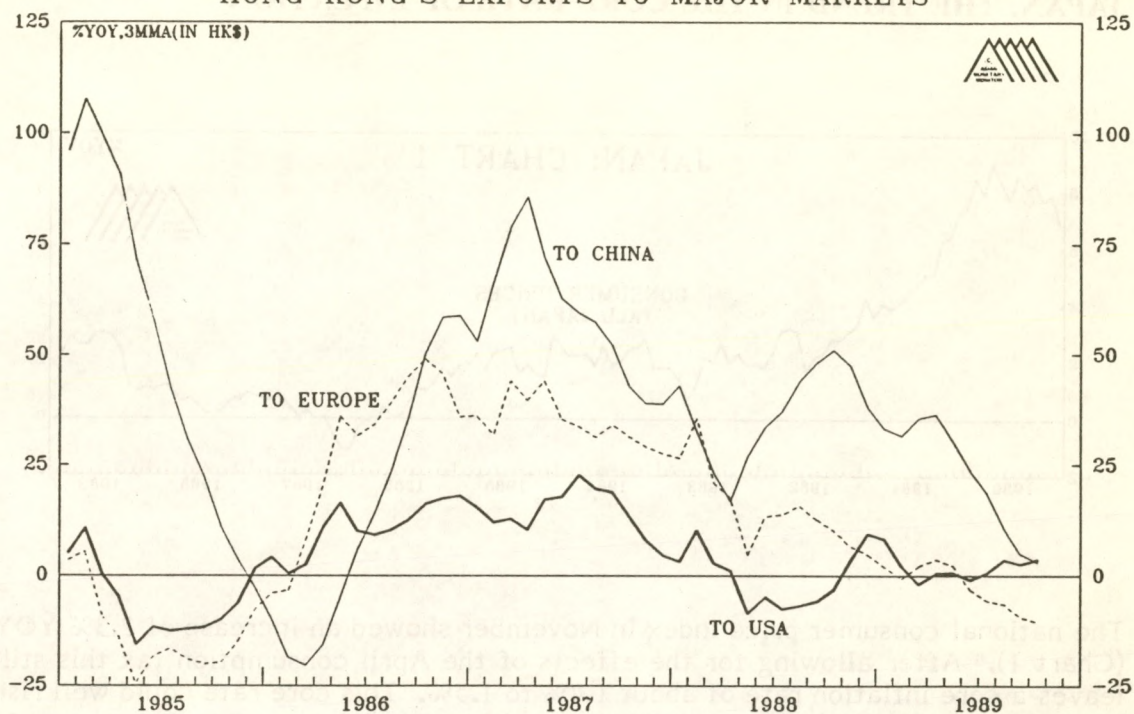


Hong Kong's domestic export growth rate has been on a declining trend since late 1987. In common with the other Asian newly industrialised economies (apart from Singapore) Hong Kong lost export competitiveness during 1988 and 1989 as the US dollar (to which the Hong Kong dollar is fixed) appreciated against the yen and the European currencies, and as inflation in Hong Kong rose. This loss of competitiveness is indicated in the chart above by the rise in the real effective exchange rate. In addition, the slowdown in domestic demand growth in the USA has resulted in a poorer export environment for all of the Asian NICs.

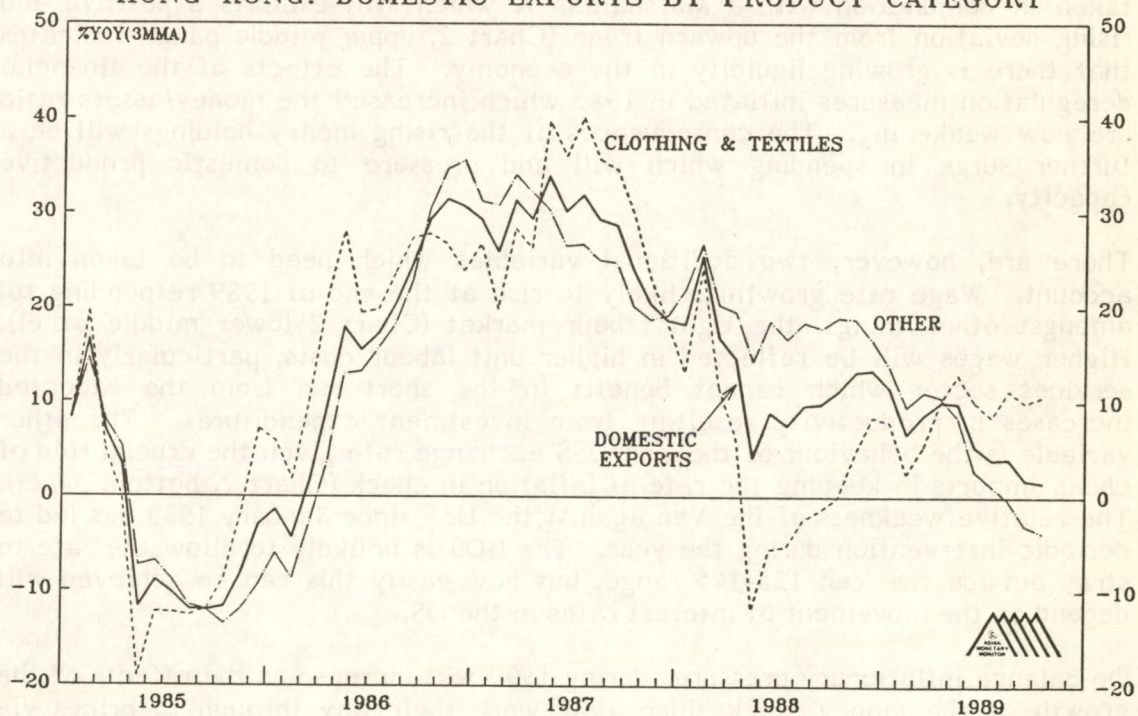
Hong Kong's export growth weakened particularly sharply in early 1988, recovering somewhat in later 1988 and early 1989 before weakening again subsequently. As the charts opposite show, these fluctuations in Hong Kong's overall domestic exports performance have reflected the behaviour of Hong Kong's domestic exports to the US, which account for one-third of the territory's total domestic exports. Because nearly half of Hong Kong's domestic exports to the US are clothing and textiles, the behaviour of this category of goods is the single most important influence on the growth of Hong Kong's exports to the US. During 1988 clothing sales in the US were particularly weak but during 1989 clothing has been one of the stronger areas of US consumer spending. An associated recovery in Hong Kong's overall clothing and textile exports has allowed total export growth to remain positive even as exports of other goods have weakened sharply (bottom chart).

The growth of exports to Europe has fallen consistently since early 1987. The extent of weakness in export volumes to Europe has been surprising given the comparative strength of the European economies. Although there may be scope for a recovery in these exports from current negative growth rates, unfortunately the overall trade outlook for Hong Kong for at least the next six months is not encouraging. The Chinese economy (18% of Hong Kong's domestic exports) is likely to remain in recession. Furthermore, it is doubtful that positive export growth to the US can be sustained solely on the back of strong clothing shipments when the trend to weaker overall US domestic demand remains intact. Therefore, it is quite likely that Hong Kong's overall export growth rate will turn negative during the early months of 1990.

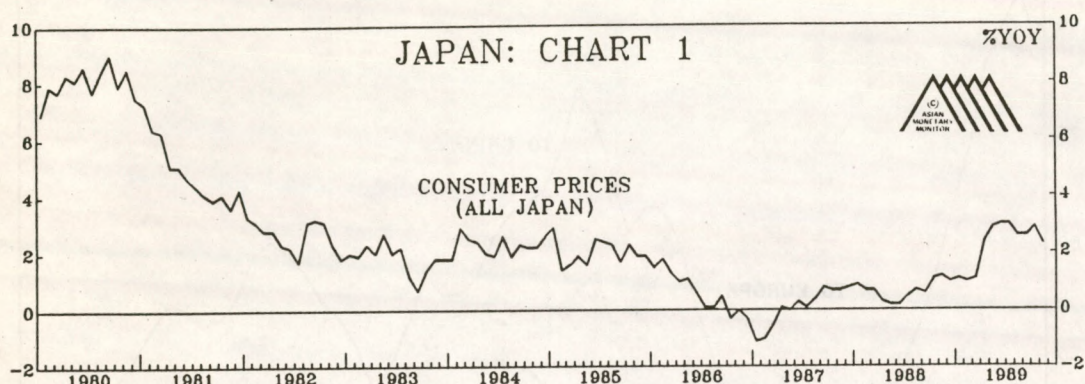
HONG KONG'S EXPORTS TO MAJOR MARKETS



HONG KONG: DOMESTIC EXPORTS BY PRODUCT CATEGORY



JAPAN: THE TREND IN THE CORE RATE OF INFLATION



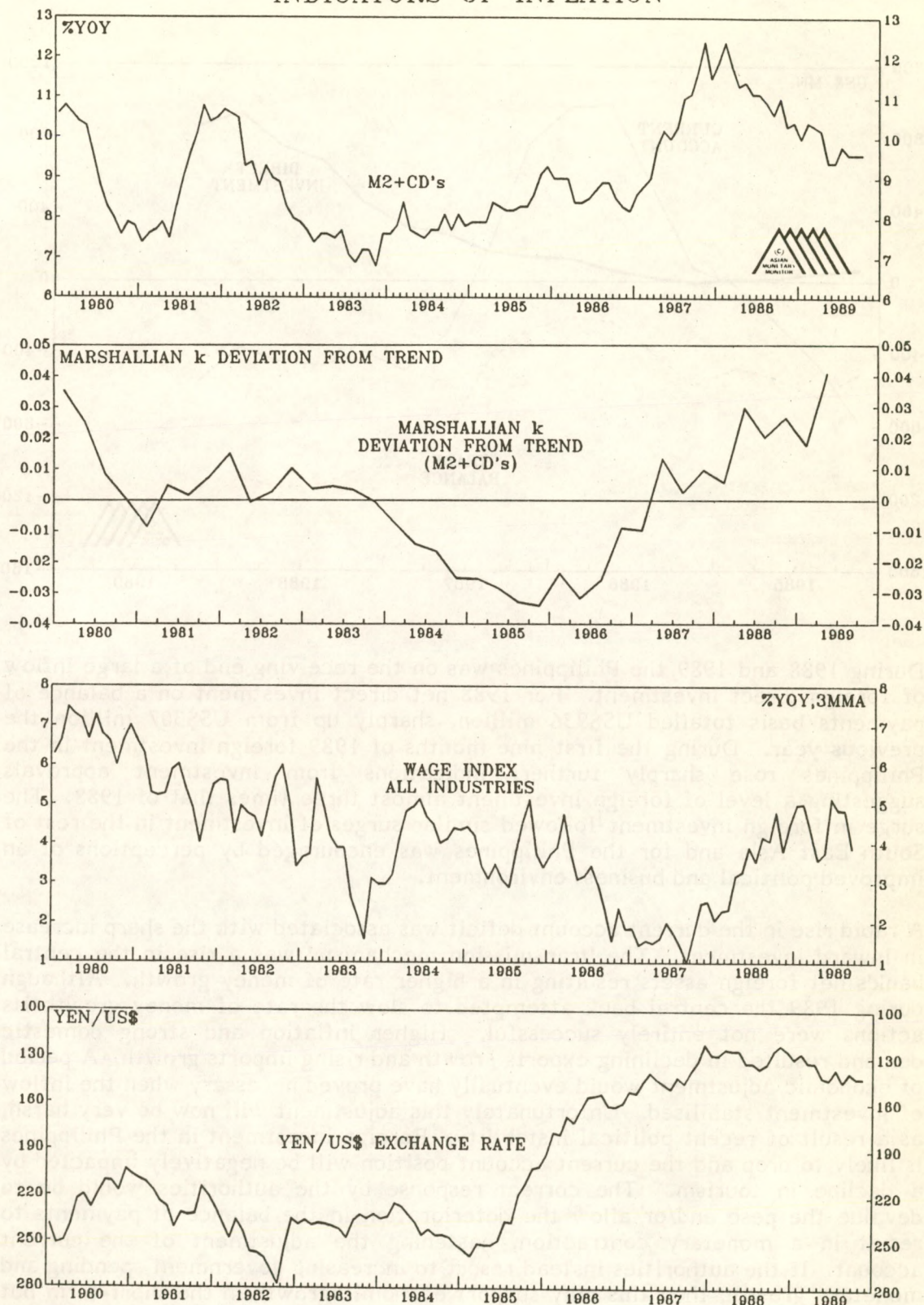
The national consumer price index in November showed an increase of 2.3% YOY (Chart 1). After allowing for the effects of the April consumption tax this still leaves a core inflation rate of about 1.4% to 1.5%. This core rate could well rise towards the end of 1990 to 2.3%-2.8% given the underlying monetary pressures in the economy.

The rate of growth of the money stock is stabilising but during 1989 it has still maintained an average growth of about 9.8% YOY (Chart 2, top panel). This, taken in conjunction with a Marshallian K which still exhibits a positive and rising deviation from the upward trend (Chart 2, upper middle panel) indicates that there is growing liquidity in the economy. The effects of the financial deregulation measures initiated in 1985 which increased the money/assets ratio are now weakening. The consequences of the rising money holdings will be a further surge in spending which will add pressure to domestic productive capacity.

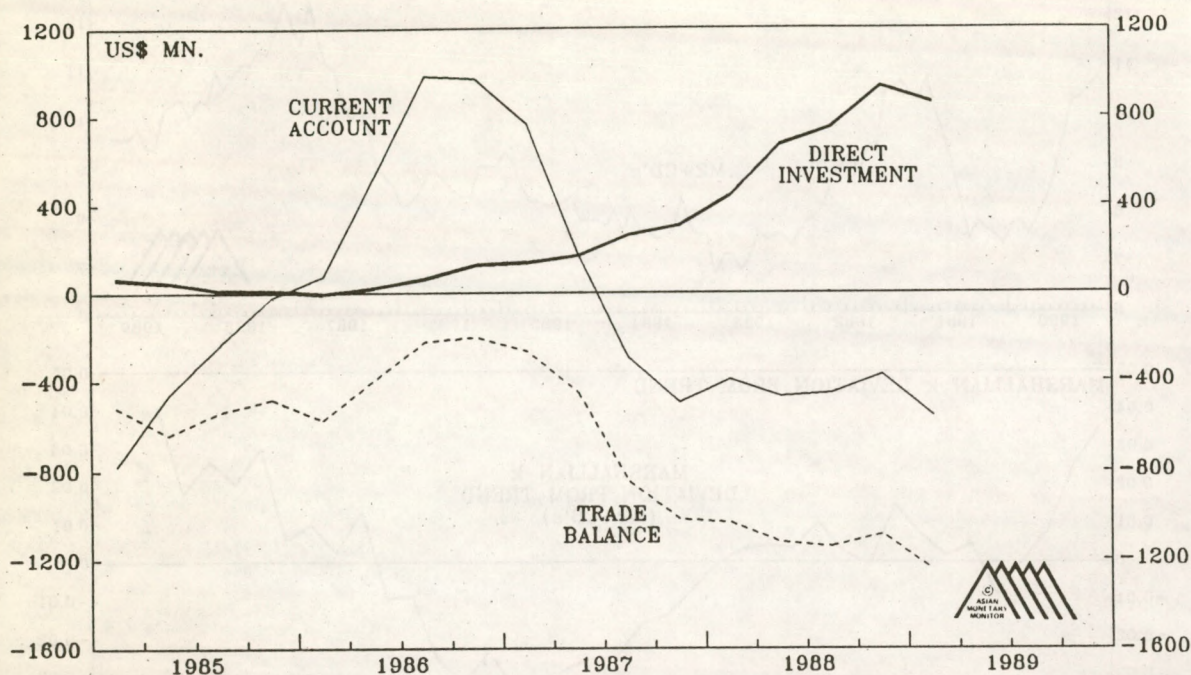
There are, however, two additional variables which need to be taken into account. Wage rate growth is likely to rise at the end of 1989 responding to, amongst other things, the tight labour market (Chart 2 lower middle panel). Higher wages will be reflected in higher unit labour costs, particularly in the services sector which cannot benefit in the short run from the expected increases in productivity resulting from investment expenditures. The other variable is the behaviour of the Yen/US\$ exchange rate given the crucial role of cheap imports in keeping the rate of inflation in check (Chart 2, bottom panel). The relative weakness of the Yen against the US\$ since January 1989 has led to periodic intervention during the year. The BOJ is unlikely to allow the rate to stray outside the Yen 135-145 range, but how easily this can be achieved will depend on the movement of interest rates in the US.

On balance inflationary pressures during 1990 will increase as the effects of the growth of the money stock since 1987 work their way through to prices via increased spending. These pressures will be moderated or intensified by the movements in the exchange rate and in wage rates.

JAPAN: CHART 2 INDICATORS OF INFLATION



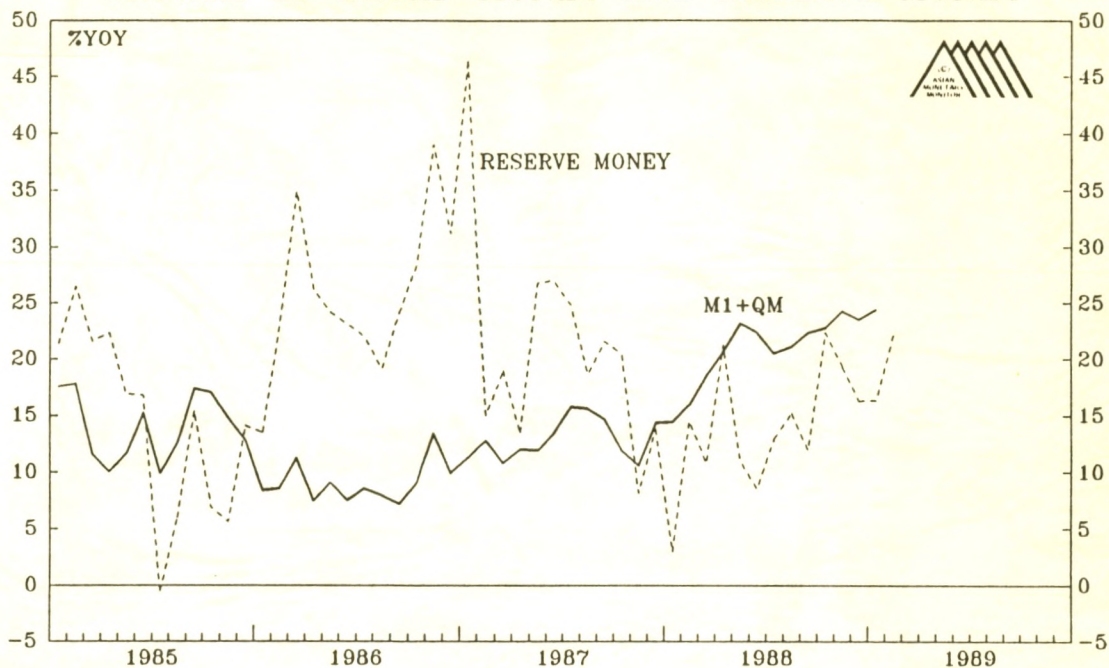
PHILIPPINES: A DIFFICULT ADJUSTMENT LIES AHEAD



During 1988 and 1989 the Philippines was on the receiving end of a large inflow of foreign direct investment. For 1988 net direct investment on a balance of payments basis totalled US\$936 million, sharply up from US\$307 million the previous year. During the first nine months of 1989 foreign investment in the Philippines rose sharply further, indications from investment approvals suggesting a level of foreign investment almost three times that of 1988. The surge in foreign investment followed similar surges of investment in the rest of South East Asia and for the Philippines was encouraged by perceptions of an improved political and business environment.

A rapid rise in the current account deficit was associated with the sharp increase in inward investment. The 'transmission mechanism' was a rise in the central bank's net foreign assets resulting in a higher rate of money growth. Although during 1989 the central bank attempted to slow the rate of money growth its actions were not entirely successful. Higher inflation and strong domestic demand resulted in declining exports growth and rising imports growth. A period of economic adjustment would eventually have proved necessary when the inflow of investment stabilised. Unfortunately this adjustment will now be very harsh, as a result of recent political instability. Foreign investment in the Philippines is likely to drop and the current account position will be negatively impacted by a decline in tourism. The correct response by the authorities would be to devalue the peso and/or allow the deterioration in the balance of payments to result in a monetary contraction, hastening the adjustment of the current account. If the authorities instead resort to increasing government spending and monetary growth, then this may support economic growth in the short-term but at the cost of high inflation and a much more painful economic adjustment later.

THE PHILIPPINES GROWTH OF BROAD MONEY AND RESERVE MONEY



THE PHILIPPINES GROWTH OF CONSUMER AND WHOLESALE PRICES

